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BUSINESS VALUATION UPDATE
TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

Key Points From the VSCPA Forensic and Valuation Conference

The annual two-day Forensic and Valuation Conference hosted by the Virginia State Society of CPAs is one event we never miss. This year, we were happy to see some younger practitioners joining the veteran and well-known speakers in presenting the sessions. Conference chair Harold Martin (Keiter) acted as host and thanked a task force that put together the event, which was also livestreamed to state CPA societies in New Jersey and Connecticut. Here are some key points from all of the sessions.

Economic update. A recession is still expected during 2024, reported the lead-off speaker, economist Christine Chmura (Chmura Economics & Analytics). A little more than half of the audience in the room agreed with that, but some people wondered whether we already had a recession right after COVID-19. There was no recession, according to the National Bureau of Economic Research (NBER), the "arbiter" of these matters in the U.S.—there needs to be two straight declines in the GDP for there to be an official recession.

Inflation has come down, but the Fed's target of a 2% rate has not yet been met, she noted, adding that a mild recession is expected for the following reasons:

- It is not expected that inflation will quickly drop to 2%;
- The Fed will raise the funds rate target one more time (it takes one year or longer for increases to impact the economy; homes, autos, and capital expenditures become marginally more expensive so demand drops; recession historically occurs about a year after the yield curve inverts);
- Consumer indicators are showing signs of weakness (credit card usage, delinquencies are increasing; student loan repayment has started; federal stimulus to households from the pandemic ended); and
- GDP will be below potential for the next two years, and the unemployment rate will increase to about 5%.

Chmura pointed out that recession does not equally impacted all industries. Durable goods firms are hit the hardest, and warehousing and construction have already pulled back. On the other hand, due to demographics, healthcare should continue to grow. Federal spending and reshoring will support some industries, such as semiconductors and pharmaceuticals.

Annual BV update. Every year, Jim Hitchner (Financial Valuation Advisors Inc.) does a fabulous review of important topics and developments in valuation practice. One issue he discussed was recent research from Roger Grabowski (Kroll) and Dr. Ashok Abbott (West Virginia University) on whether long-term growth rates are too high, citing an article in this newsletter.[1] Many analysts use long-term real GDP growth plus expected inflation in their terminal values, but that "is just flat wrong," the article quotes Grabowski

1 "Typical Way to Estimate Long-Term Growth Is 'Flat Wrong,' Says Grabowski," *Business Valuation Update*, Vol. 28, No. 2, February 2022.

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as saying. GDP includes both existing firms and new firms, whose growth is driven by acquisition. Therefore, the expected long-term growth rate should reflect "organic" growth, with the effect of the acquisitions backed out. For their research, Grabowski and Abbott removed the growth in years when the firms made significant acquisitions and/or conducted significant divestitures.

Hitchner noted that he is not at this point using the recommendations in this new research. But, in the previous session, economist Chmura was asked about this concept, and she remarked that it "makes sense."

On another topic, the IRS has been aggressively targeting appraisers of conservation easements for charitable deduction purposes. Hitchner believes this crackdown will "bleed into" business valuation and that estate and gift tax work will no longer be "low risk." The Inflation Reduction Act gave the IRS a big funding boost, and it has been hiring more business valuation experts to add to its ranks. He remarked that he knows some BV firms that the IRS has already targeted over appraisals.

On other topics, Hitchner took a "fresh look" at the guideline company transactions and guideline public-company methods, talked about bad versus good language in valuation reports, how to use both the new and old glossaries of business valuation terms, results from various polls he conducted, and some advanced expert testimony tips. He also mentioned that the new edition (fifth) of his book, *Financial Valuation: Applications and Models*, will be out later this year or early 2024.

Goodwill. Every jurisdiction is different when it comes to goodwill. In a marital context, personal goodwill is included in the marital estate in some jurisdictions, so the analyst must separate personal from enterprise goodwill. Ron Seigneur has his firm based in Colorado, where this is not an issue—all goodwill, both enterprise and personal, is part of the marital estate. But, when you have to break it out, the analyst must also know the methods that the court prefers—and it can differ among courts in the same state.

Some courts like the excess earnings method, which Seigneur noted is referred to as "the most used and abused" business valuation method in common use. He went through a specific example for applying and interpreting the excess earnings method. Other methods include the multiattribute utility model (MUM), a simplified version of MUM, the with and without (owner or key person) approach, the "residual method" (like a purchase price allocation for tax purposes), and some others. In some cases, it is possible to use mathematical models to link personal goodwill to quantifiable customer retention.[2]

All of these methods have their pros and cons, but the important thing is to have some analytical "framework" of thinking that will support your opinion. Seigneur recalled a court case where the other expert prevailed because he had a MUM-like framework for estimating company-specific risk. The judge preferred it because, although it is still very subjective, there was a "method to the madness," so to speak. Seigneur remarked that, since then, he includes that type of framework in all his valuation reports.

Another thing to note is that, within the concept of personal goodwill, a new variation has emerged—breaking it into two components: (1) transferrable (salable) personal goodwill; and (2) "pure" personal goodwill. In a Wisconsin case, the court broke new ground in divorce law when it held that all the salable personal goodwill in a professional practice (as evidenced by a non-compete agreement) is a divisible marital asset.[3]

Medical practice specialties. "All the things I didn't want the rest of you to know," said Mark Dietrich, nationally known healthcare valuation expert who recently retired from active practice. He now devotes his time to research, speaking, and writing. For instance, his extensive research debunks the use of surveys for determining reasonable compensation in favor of a relative value unit (RVU) analysis.[4]

In his session, he offered advice on valuing specialty medical practices.

Dietrich stressed that a revenue analysis by Current Procedural Terminology (CPT) code is crucial for the valuation of any physician practice. He likened it to valuing an insurance agency—you need to analyze the types of policies and renewals. CPT codes are an industry standard for coding medical procedures and services. If the practice is not forthcoming with these data, Medicare claims data for every physician in the country are located on the CMS website.[5] These data can be sorted by physician specialty, state, locality, etc. or any combination thereof.

For practices that make significant use of the codes for office visits (evaluation and management (E&M) codes), he noted that income can be manipulated in anticipation of the physician's divorce or an M&A deal (yes, it happens). This type of scheme puts added importance on a multiyear coding analysis. Of course, this upcoding or downcoding could be inadvertent, but it still should be examined.

Dietrich remarked that he uses an Excel VLOOKUP function to summarize the services by major category using the Professional Edition of the AMA's CPT Guide (a "must have" guide),

2 Claudia J. Stern, CPA/BVA/CFF, and Carl S. Saba, MBA, CVA, "Quantifying Personal Goodwill by Analyzing Customer Retention," *Business Valuation Update*, Vol. 23, No. 11, November 2017.

3 *McReath v. McReath*, 2011 WL 2706249 (July 12, 2011), which is available at *BVLaw*.

4 A free RVU calculator is available at chipsblog.pcc.com/free-2023-rvu-calculator.

5 data.cms.gov/provider-summary-by-type-of-service/medicare-physician-other-practitioners/medicare-physician-other-practitioners-by-provider.

and he assigns individual CPT codes to these categories by using a SUMIF function.

Also, practice expenses RVU (peRVU) values must be modified to reflect site of service (a procedure done in the office versus a hospital or ambulatory surgery center). If not, your compensation calculation will be wrong.

These pieces of advice just scratch the surface, and much more is included in Dietrich's new book, *Engagement Guide to Understanding and Valuing Medical Practice Specialties,* which covers 11 different specialties and includes a sample valuation report, "something I never would have given out when I was practicing."[6]

Reasonable comp. Neil Beaton (Alvarez & Marsal) made an interesting point: Is the average valuation expert really qualified to perform a reasonable compensation analysis? Everyone in the room raised their hands when asked whether they ever had to normalize compensation for a valuation. In certain cases, such as a very large subject company with significant dollars at issue, you may need to bring in an outside expert.

But, in other situations, the average business valuer can indeed be qualified. In a recent case, an expert in valuation and forensics was challenged by the opposing side, which argued that the expert had no specific training in reasonable compensation (there are credentials for this discipline). The expert asserted that he had significant experience in business valuation and forensic examinations and was accredited as a business valuation expert by multiple organizations. He also explained that the approaches and methodologies to determine reasonable compensation are taught and made part of the training and maintenance of these credentials. The court concluded that the expert had sufficient qualifications to offer an opinion on the defendant's compensation.[7]

Beaton also discussed the various compensation benchmarking surveys and subscription databases. Be careful, he cautioned, because some of these are "black boxes" that use algorithms to generate data that could be challenged (he had a case where that was an issue). ERI was one that was mentioned that does not give the recipe for its "secret sauce." Therefore, make sure you know what's underlying the data—and use multiple sources in case one gets disqualified. He also suggested examining proxy statements from public companies for compensation data.

On the hot seat. Harold Martin moderated a panel on expert witness testimony in valuation matters with Ron Seigneur, Neil Beaton, Kristopher Boushie (NERA Economic Consulting), and attorney Martin Cunniff (Fields Han Cunniff). Some good tips and insights:

- Judges really don't care whether you don't have specific industry experience, as long as you know what you're doing (the economics of different industries can be the same);
- If you get a yes or no question, don't worry whether you can't say all you need to say—you can do it on redirect ("redirect is your friend");
- If you're testifying for the first time and get grilled on it, turn it to your advantage by saying you "overprepared" and point out how many engagements you had that didn't get to court;
- "Did you do all the actual work on this report?" is a typical challenge question—if you did not, just say you delegated some of the work just like attorneys do, and the valuation standards allow it;

6 bvresources.com/products/engagement-guide-to-understanding-and-valuing-medical-practice-specialties.

7 *Pinto v. Schinitsky*, 2022 N.Y. Misc. LEXIS 5601; 2022 NY Slip Op 33360(U); available on the *BVLaw* platform

- "Is that valuation book you quoted authoritative?" is another tricky question and the answer is "no"—the books are not authoritative, but they contain authoritative information (the only authoritative sources are the professional standards); and

- If the opposing attorney gets too aggressive and keeps firing questions relentlessly, ask him or her to repeat the question—that will break the rhythm.

Harold Martin credited Gary Trugman (who did the next session) with giving him the best piece of advice: If you want to become a testifying expert, then teach. Speaking in front of an audience and fielding questions is a great training ground for becoming an expert witness.

Avoiding common errors. Gary Trugman (Trugman Valuation) did a session that was—as usual—a very practical discussion about the issues that all analysts run into when valuing small businesses and professional practices. His view is that, overall, nothing has really changed in valuation practice, except that analysts know more now, and they can't "get away" with things as they did before. The practice is more rigorous, and methodology has become more sophisticated.

Also, his view is that small businesses have very little correlation with public companies ("if you think differently, you're nuts") but the market approach must be considered in every engagement and can be used as a sanity check. A question from the audience: What if the market approach is way off—do you include it in your report? No! If the sanity check shows insanity, why include that? If it's way off and you do not rely on it, leave it out of your report but put it in your workpapers, he advised. That way, if you get asked whether or not you considered it, you'll be covered.

Another question: Do you use rules of thumb? "Absolutely," he responded. But only as a sanity check and also you will get asked about it, either by your client or the opposing attorney in litigation. As for the source he uses, he mentioned that he gets Tom West's *Business Reference Guide* every year (and there's also an online version).

Another sanity check he mentioned was the "justification for purchase test," also known as the "business broker's method" because they use it to price a business for sale. This test is designed to determine whether the cash flow that the business is forecasted to generate will adequately cover the debt payments that will result from the acquisition of the business, assuming normal business terms (e.g., a realistic down payment, interest rate, and term for the financing). An example of this test is in Chapter 17 of his book, *Understanding Business Valuation,* 6th edition.[8]

Using options. After sessions presented by the "old guard" of the profession, two of the "young guard," Asif Charania and Gregory Saunders, who work with Harold Martin at Keiter, presented the final session. They gave a good overview of the usage of option pricing models (OPMs) to value securities in a complex capital structure (e.g., in a stock-based compensation engagement), as well as their application for estimating discounts for lack of marketability. They included some case studies for various approaches and purposes.

They also talked about the use of Monte Carlo simulation to test management's projections. Monte Carlo is best to use when estimations for growth are uncertain or volatile, they advised. Once you build your DCF model, you identify the assumptions you would like to simulate and define the upper and lower bounds for revenue growth and operating margins. Different types of probability distributions may be appropriate (e.g., lognormal, triangular, uniform, etc.) depending on the variable, they noted. Management's

8 bvresources.com/products/Understanding-Business-Valuation-6th-edition.

base case scenario or an average of various projections can be used as the mean, and the standard deviation can be estimated based on historical results or the difference in management's scenarios. They gave an example of Monte Carlo simulations to test the effect of changes in revenue growth and operating expenses as variables. When this type of approach is used, the speakers advised that you consider reducing the DCF discount rate due to the shifting of risk analysis.

Final note. After chairing this event for the past 20 years, Harold Martin will be handing over the reins starting with next year's event. This is a fabulous example of giving back to the profession, so we urge other practitioners to follow his lead. This can mean helping to organize events like this, speaking at conferences and webinars, writing articles, and the like. No matter what organization you belong to, volunteer opportunities are available, so please take advantage of them. ◆