VALUATION

Uncharted Territory: Impact of COVID–19 on the Valuation Profession

By Daniel Shiffrin, Editor, The Value Examiner

Seemingly overnight, the COVID-19 pandemic has affected nearly every aspect of public life in every corner of the globe. And while our highest priority should be the health and safety of our families, friends, colleagues, and communities, the pandemic's economic impact is a close second. For valuation professionals, the crisis has a wide-ranging impact on their practices, affecting everything from the valuation process itself to client relations, practice management, business development, and information security.

Here is what some of the experts are saying.

Valuation Analysis in Uncertain Times

Valuation practitioners are accustomed to dealing with uncertainty created by external factors, such as economic and market conditions, political events, regulatory developments, natural disasters, and even outbreaks of illnesses. But COVID-19 is different, in part because issues with testing and a limited understanding about how this new virus spreads make it difficult to predict its ultimate impact.

Valuations under the market approach will be particularly challenging. "I believe valuation analysts utilizing valuation dates after January 31, 2020—or possibly as early as December 31, 2019—and likely through the remainder of the year, should use caution when relying primarily on the guideline public company method," says Donald Price, CVA, ASA, managing director of business valuation and litigation support at Baker Tilly in Southfield, MI. "The EBITDA and revenue valuation multiples derived from public companies are going to be all over the place for the foreseeable future," Price observes, and "even if adjustments are made to the multiples, they will likely be more subjective than empirically supported." That is not to say that the subjective component is a bad thing. Arguably, it reflects what valuation analysts are ultimately trying to capture: the *market's* perspective of the value of businesses as of the valuation date.

What about the income approach? Often, Price says, "the capitalization of cash flow (CCF) method is best suited to the valuation of mature companies with steady earnings. But in light of current volatility and the expected short-term decline in economic conditions, it may make sense to look at two or three years of discounted cash flow when valuing these mature, stable companies. This allows the valuation analyst to capture the current disruption to business and then return to a 'normal' level of profitability."

Lari Masten, MSA, CPA, ABV, CFF, ABAR, MAFF, director of Masten Valuation in Greenwood Village, CO, agrees. Masten asserts that "for the foreseeable future, depending on the appropriate treatment of subsequent events, the CCF model should probably be shelved in favor of preparing a discounted cash flow (DCF) model. In the next few years, some analysts may adopt a CCF model that simply applies no weight to 2020 and possibly 2021, but that historical-based model and weighting will probably not have accounted for long-term changes to revenues, expenses, and necessary changes to business models moving forward and past COVID-19."

Greg Reagan, CPA, CFF, ABV, CFE, CVA, managing member of Reagan FVL, LLC, in Charlotte, NC, comments that "when it comes to using the CCF or DCF methods, the specific industry and company will drive the method of choice. While some companies in certain industries are not reporting a significant impact, all are affected to some degree. Some industries are actually benefiting from this crisis. In certain circumstances, a CCF method may still be useful. But DCF may make better sense for heavily leveraged businesses and those in struggling industries that are having difficulty accessing needed capital to ride out the storm as well as those experiencing an unusual uptick in business. Will these effects continue or are they temporary?" Reagan also advises valuation professionals that "regardless of the method you choose, great care must be taken to avoid 'double counting'

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when developing assumptions about cash flow and the capitalization or discount rate. It is more important now than ever before to dig deep into industry and company specific financial and risk analyses."

With regard to developing a discount rate, Masten notes that "Duff & Phelps recently announced an increase in its recommended U.S. equity risk premium, from 5 percent to 6 percent, effective March 25, 2020."[1] This premium, she says, "should be used in conjunction with a 3 percent risk-free rate, rather than a spot rate for the 20-year Treasury rate, per Duff & Phelps published guidance.[2] Now we have our first empirical evidence emerging that equity risk premiums are up, so we can use that as a basis for increased current risk, regardless of the cost-of-capital source we elect to use."

What is Known or Knowable?

According to John E. Barrett, Jr., CPA, ABV, CBA, CVA, of Barrett Valuation Services in Cranston, RI, "the current crisis underscores the importance of the valuation date and what was known or knowable on that date." It appears that the first case of COVID-19 in China occurred as early as December 1, 2019, although it was not until December 31, 2019, that China reported a cluster of pneumonia cases of unknown cause in Wuhan. In the second week of January, Chinese health authorities confirmed that the cluster was associated with a new coronavirus, later designated COVID-19, and the first deaths from the virus were reported January 11, 2020. The first confirmed U.S. case was reported around January 20, 2020, and by the end of January 2020, a total of nearly 10,000 cases and more than 200 deaths had been reported in at least 21 countries. On January 31, 2020, the U.S. government declared a public health emergency and issued new restrictions on travel into the U.S. by persons believed to pose a risk of transmitting COVID-19.[3]

Judith O'Dell, CPA, CVA, president of O'Dell Valuation Consulting in Rockport, ME, understands firsthand the challenges involved in determining what is known or knowable on the valuation date. She is dealing with a valuation for an ESOP transaction involving a U.S. company that was issued in early March 2020, with a December 31, 2019, valuation date. "The dilemma for valuation analysts," O'Dell explains, is: "Was COVID-19 known or knowable on December 31, 2019? The fact of the disease was known, but were the effects knowable at year end? Does one consider events in China if the company is based in the U.S. and only does business in the U.S.? If the analyst concludes that the effects—that is, that the disease could spread and can be deadly—were knowable, then theoretically the analyst has to take that into account. But how is that done?"

Complicating matters further, not all businesses are affected the same way. Some—such as healthcare-related companies and technology firms that offer tools or platforms for remote work—may see revenues rise. Others, even in areas with stay-at-home orders, are deemed "essential" and continue to operate. For example, some contractors—particularly those involved with critical infrastructure projects or repairs—are considered essential. These companies remain open for business and their people are working. But will that change? What if their employees get sick or their supply chains are disrupted and they are unable to meet their contractual obligations? "As an analyst," O'Dell says, "I don't know how to deal with these unknowns other than to increase the discount rate to reflect the risk. But how high?" After referring to professional standards (see below), she added a subsequent event appendix to the report to describe the COVID-19 situation.

In some transactions, it is possible to use earnout provisions or other techniques to hedge the buyer's risk of overpaying. In the case of O'Dell's ESOP transaction, for example, "there will be a one-year clawback provision in the seller's

1 Carla Nunes and James P. Harrington, "Duff & Phelps Recommended U.S. Equity Risk Premium Increased from 5.0% to 6.0% Effective March 25, 2020," March 27, 2020, https://www.duffandphelps.com/insights/publications/cost-of-capital/us-equity-risk-premium-increased-march-25-2020.

2 Ibid.

3 For more information about the COVID-19 timeline, see Michelle L. Holshue, M.P.H. et al., "First Case of 2019 Novel Coronavirus in the United States," *New England Journal of Medicine,* March 5, 2020, https://www.nejm.org/doi/full/10.1056/NEJMoa2001191; James R. Hitchner, CPA, ABV, CFF, ASA and Karen A. Warner, MA, "COVID-19: A timeline of significant events, including the pandemic's effect on the U.S. stock market," Valuation Products and Services, accessed April 17, 2020, https://www.valuationproducts.com/wp-content/uploads/2020/04/vps_hitchner-covid-19-timeline.pdf

note," O'Dell explains, "to kick in if the company's value declines as a result of circumstances caused by COVID-19. A reasonable solution."

What Do the Professional Standards Require?

Professional standards emphasize that valuation analysts should consider only circumstances existing on the valuation date and events occurring up to that date, even if subsequent events affect the subject's value. For example, AICPA VS Section 100 (Formerly AICPA SSVS No. 1) states that "Subsequent events are indicative of conditions that were not known or knowable at the valuation date, including conditions that arose subsequent to the valuation date. The valuation would not be updated to reflect those events or conditions."

Even if COVID-19 is deemed to be a subsequent event, the valuation analyst has an obligation to assess its potential impact on the value opinion and consider disclosing this information in his or her report.

The difficulty in assessing the impact of COVID-19 is that there is no definitive date when an "event" took place or "conditions" arose. Barrett recalls that in July 2001, he valued a large car rental business located near an airport for divorce purposes. Not long after he completed the valuation, 9/11 happened, which had a devastating impact on the business, but by then the case was closed. Unlike 9/11, which happened in the blink of an eye, the conditions surrounding COVID-19 have evolved over several months. The challenge for valuation analysts will be to determine, for a particular valuation date, whether the economic impact of COVID-19 was known or knowable on that date or whether it is a "subsequent event" that should not be considered in calculating value. One could argue that it was known or knowable as of December 31, 2019, but it is also reasonable to conclude that it became known or knowable at a later date, such as January 31, 2020, when the U.S. declared a public health emergency or even late-February/early March 2020, when the U.S. stock markets first began to react to the threat.

Even if COVID-19 is deemed to be a subsequent event, the valuation analyst has an obligation to assess its potential impact on the value opinion and consider disclosing this information in his or her report. VS 100, for example, provides that "In situations in which a valuation is meaningful to the intended user beyond the valuation date, the events may be of such nature and significance as to warrant disclosure (at the option of the valuation analyst) in a separate section of the report in order to keep users informed.... Such disclosure should clearly indicate that information regarding the events is provided for informational purposes only and does not affect the determination of value as of the specified valuation date."

Masten feels that COVID-19 demands such disclosure, arguing that "not including commentary or consideration and some level of quantification in our reports will mislead lenders, investors, and decision makers using our valuation services." She also urges NACVA members to review several aspects of the association's Professional Standards before issuing a valuation report as of December 31, 2019, or later. They include:

- Are there **scope limitations** to consider and explain that affect the level of reliance on the information? Examples include (1) the valuation date is before COVID-19 became known or knowable but the pandemic will have an impact on value, or (2) the report's due date or use date will occur before the impact can be properly assessed.
- Is there **sufficient relevant data** to make normalizing adjustments/valuation conclusions?
- Should **subsequent events** be considered and disclosed? And, if the valuation is meaningful to users after the valuation date, practically speaking, is there a duty to go beyond "disclosure" and provide an alternate valuation conclusion that accounts for these events or, at a minimum, disclose to the client verbally that your opinion *is* different now, but not yet quantifiable?
- Did the valuator rely on **hypothetical conditions?** Reports that express a conclusion of value or present a calculated value should state any "hypothetical conditions/assumptions and the reason for their inclusion."

Masten suggests that "there will, no doubt, be many hypothetical conditions and assumptions embedded in our determination of the benefit stream, on both a short-term and long-term basis, when grappling with the impact of COVID-19 on business values."

Impact on Practice Management

In a recent blog post,[4] Marc Rosenberg, a leading consultant to CPA firms, offered some advice on how professional service firms can respond to the current crisis. First and foremost, professionals need to get accustomed to working remotely. And, explains Rosenberg, "hand-in-hand with remote working is flexible scheduling. This needs to become the new normal. [P]artners and managers must become experts at evaluating performance based on *work results*, not hours worked."

It is also critical to conduct partner meetings and retreats via videoconferencing, to train clients on how to communicate digitally, and to ramp up the use of online appointment setting. Rosenberg observes that "many of our clients have been 'conscientious objectors' when it comes to using client portals and video conferencing," but this has to stop.

Now is also the time to create a written disaster plan if you do not already have one. According to Rosenberg, the plan should have "continuing action steps, such as rigorous training of our personnel and clients and focus groups of firm personnel to get their ideas for managing future crises." Given the "enormous scale" of the COVID-19 crisis, Rosenberg urges firms to "hold their partners and staff accountable for compliance with the firm's disaster policy." Among other things, that means making violations of the firm's written virus safety program grounds for dismissal and ensuring that partner compensation systems take into account "being good corporate citizens—complying with the firm's policies and procedures." Rosenberg also suggests that firms:

- Revise partner buyout plans in light of COVID-19's potential impact. "Death and disability provisions will need to be revisited regarding the relaxing of vesting provisions for older partners who, God forbid, contract the virus."
- Adapt business development and marketing activities to the current social distancing environment. "CPA firms will have to figure out ways to bring in business with less reliance on face-to-face meetings with prospects and referral sources."
- Put more things in writing. Firm leaders may be "leery of putting an excessive amount of energy into written policies, procedures, and processes for fear of being perceived as heavy-handed…but with the reduction in face-to-face interaction, it may be prudent to ramp up the number of written instructions to ensure that work processes are crystal clear."

Information Security Best Practices

One byproduct of the pandemic is that many firms are encouraging or requiring their employees to work from home if possible. As a result, it is critical to pay close attention to information security to avoid compromising your firm's or your clients' sensitive information. In a recent blog post,[5] Tommy Stephens—a shareholder of K2 Enterprises, a leading provider of technology CPE and consulting—shared five security best practices:

1. Do not use unsecured Wi-Fi. Unsecured Wi-Fi networks, at home or elsewhere, make it easy for cybercriminals to intercept data transmitted over those networks. Stephens advises remote workers to "protect the network, at a minimum, by requiring a password to establish a connection." Another option is to avoid Wi-Fi altogether and use wired connections. "Not only will they be more secure, but they might also be faster."
2. Use a VPN. A virtual private network (VPN), Stephens explains, creates "a secure, encrypted 'tunnel' in the otherwise unencrypted Internet…[adding] yet another level of encryption to your data." Many firms' IT departments already have a VPN option in place for connecting to their networks remotely. Another option is for employees to use one of the many "personal VPN" services that are available.
3. Understand BYOD risks. If employees work remotely on their own computers, be aware of "bring your own device" (BYOD) risks. Firm-provided devices maintained by IT staff likely contain all necessary security features, but personal devices may not. Stephens recommends that staff working at home use firm-provided devices, but if they must use personal devices, "at a minimum, ensure that [their] operating system[s] and all [their] applications have the most recent updates available. Also, verify that anti-malware software is installed on the computer and is updated at least daily."

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4 Marc Rosenberg, "COVID–19: How Your Firm Can Respond," March 16, 2020, https://rosenbergassoc.com/covid-19-how-your-firm-can-respond/.

5 Tommy Stephens, "Responding to COVID–19 with Remote Access? Pay Attention to Security!," March 17, 2020, https://www.k2e.com/articles/remote-access-security/.