RISCPA'S
ETHICAL ISSUES IN BUSINESS VALUATION – HOW TO AVOID A TRIP TO THE ETHICS BOARD

Wednesday, December 16, 2020
From 1:00 P.M. to 3:00 P.M.

Presenter:

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AGENDA

- A Review of the NACVA Business Valuation Standards
- Ethical Issues
- Avoiding Hidden Biases
- DO’s and DON’Ts in Litigation Cases
- Common and Uncommon Errors to Avoid
- Suggestions to Improve Our Valuation Performance

A Review of the National Association of Certified Valuators and Analysts Professional Standards

Please see separate document attached.

Commentary from:
Wenlie Zhou, CPA, ABV
WEN Consulting, LLC
and
Kevin A. Papa, CPA, ABV, CVA
Picerelli, Gilstein & Company, LLP

The NACVA website has an excellent Business Valuation Standards comparison chart comparing the NACVA, AICPA, USPAP and ASA Professional Standards.

GENERAL AND ETHICAL STANDARDS

Integrity and Objectivity

- Conflict of interests?
- 3rd party influences (attorneys advocating for clients)

Professional Competence

Question: How do we know what we don't know?

Ethical Issues in Business Valuation

Ethical lapses

- Ethics is defined as…a system of moral principles. …Ethics is concerned with what is good for individuals and society and is also described as moral philosophy. The term is derived from the Greek word ethos which can mean custom, habit, character or disposition.
- To be unethical suggests bias:
  - Undertaking a divorce valuation for the propertied spouse when your CPA firm provided services to both parties in the past.
  - Purposefully providing a high (or low) value indication in a valuation report without recognizing that parties view your work as unbiased and objective.

Judge's Comments on Experts (RE: Lund Food Holdings, Inc.)

- "Zealous advocacy in which they engaged on behalf of their respective clients compromised their reliability in this instance."
- "The elaborate undertaking, given that the experts – presumably to advance the incentives of their respective clients – disagree as to essentially every input and assumption contemplated in their DCF calculations."
- "It is absolutely clear that their valuations are tailored to suite the party who is paying them. This cold fact cuts against both experts' <u>credibility</u> in equal measure."

Eight+ Reasons to be Ethical

1. Avoid litigation
2. Avoid increased regulation
3. Positive public perception
4. Trust of suppliers and partners
5. Customer loyalty
6. Employee recruitment, engagement, and retention
7. Personal pride
8. It’s required by our profession

- Can Ethics Be Taught?

- What Are Key Elements Related to Ethical Business Valuations:
    - Effectively listen to the client, follow the Standards, your own ethical principles and your own conscience and you will determine what is appropriate.
    - What about lying, embellishing, omitting facts or stretching the truth? The Harvard Business Review research suggests that people acting on behalf of others can be influenced by the values and perceived expectations of those they are representing – specifically when it comes to acting ethically. People tend to act unethically when representing others, if they believe others are okay with it or prefer it.

- Dealing with Ethical Dilemmas
    - In litigation cases, the attorney advocates for the client's case. The business valuation expert must only advocate for his or her opinion of value.
    - What happens, if the expert does an analysis for an attorney representing the owner spouse, in divorce, if the expert develops a capitalization rate of 20.0%, and the attorney, aiming for a low valuation, prods the expert to use a higher cap rate?

- For Each Ethical Issue Ask Yourself – Is This The Right Thing To Do?

AVOIDING HIDDEN BIASES

The following is from an article by Zack Meyers

Thou Shall Avoid Bias at all Costs

Financial experts should avoid bias at all costs. Bias exists by virtue; a very human tendency to learn through experience and make decisions accordingly. The pervasive nature of bias can, at times overwhelm our thought process despite every attempt to shed this flawed thinking from our subconscious. Forensic accountants and valuation professionals have a responsibility to the court to render an unbiased (neutral) opinion of damages or business value while having what clearly can be defined as a direct financial interest with a plaintiff, defendant, petitioner, or respondent. This inherently conflicted role places an extreme amount of pressure on experts to use bias to inflate or deflate damages or conclude an artificially high or low value of a business in a divorce. If you are known for inflating or deflating damages or convincing family law courts of your unsupported opinions of value, you are likely breaking more than a few rules and regulations along the way and, at a minimum, are violating many ethical provisions that are no laughing matter when you are stripped of your credentials or barred from doing valuations by the IRS for the next decade. Ironically, ethical behavior, like bias, is best taught through experience and observation.

Thou Shall be Unimpeachably Neutral

Financial experts should strive to be unimpeachably neutral in all aspects of their work. Neutrality in my opinion, is the very essence of what an expert witness should strive for, as the primary obligation of an expert witness is to use our scientific, technical, or other specialized knowledge to help the trier of fact understand the evidence or to determine a fact in issue.

In Divorce Cases is a “He’s a Son-of-a-B….” Premium Allowed?

Is There a Premium or Discount Allowed, Based on Alleged Behavior?

Intentional Bias
The High-Low Guy or
The Anything for a Buck Appraiser

- This will eventually undermine your practice.
- The high-low appraiser seldom develops as a skilled appraiser.

Unintentional Bias
Business Valuation Study by:
Max H. Bazerman, from the book *The Power of Noticing*
See attachment

DO’s AND DON’Ts IN LITIGATION CASES

- Do be an advocate for your Opinion of Value.
- Do be objective, independent and fair minded.
- Do credible work.
- Treat every valuation as if a joint retention.
- Work closely with the client and the lawyer and help them understand the valuation outcome.
- Do not become That Appraiser – In the long run this will kill your reputation and future referrals.
- Do not misrepresent historical financial information.
- Do not misrepresent or alter source data.

COMMON AND UNCOMMON ERRORS TO AVOID

These examples are from Rob Schlegel's recent NACVA Ethics Course

How to really demonstrate your incompetence

Be Stupidly Subjective

- After considering all relevant factors, we have concluded that a subject risk factor of 11.25% is appropriate for the subject.
- The average control premium observed in the Mergerstat Studies was 35%, so that is what we will use for the subject.
- Numerous authorities suggest a range of discount rates from 20% to 35%, so we will use an average of these, of 27.5%.
- Average annual growth rate for the last five years is 8.9%, so we will project future income at this level.

Think through your assumptions…

- The DCF assumed completion of a new plant (that was planned for) but failed to consider the substantial capital expenditures required to build it.
- The report considered two public company transactions where the average control premium was 70.0%. The premium was applied to the initial guideline public company conclusion (about 10x EBITDA), yielding a conclusion of about 17 x EBITDA.
- The difference between a final price of $91 per share and $60 per share meant about $200 million in purchase price difference.

Let’s build-up a Discount Rate

- We estimate 2% for an additional size premium as XXX is significantly smaller than the average company in the 10b universe.
- We added no additional increment for leverage, as XXX has very low leverage relative to its peers.
- We added 1% due to the Company’s limited existing market (primarily Chicago metropolitan area).
- The Specific Company Risk Premium of 4% is appropriate for companies in this industry.

We Love the Asset Approach

- Failure to consider liquidation value in valuing controlling interest
  - Example: Net Tangible Assets = $200 while Capitalized Earnings = $70
- Giving an opinion on fair market value of real estate, machinery and equipment without experience as an asset appraiser

We Love the Market Approach

- Incompatibility (i.e. Burger King to a single location restaurant)
- Lack of comparative analysis of subject and guideline company
- Automatically applying mean or median without explanation
- Inconsistent assumptions with the Income approach (growth…)
- Cherry-picking transactions to fit expectations
- Using the DMDM with very limited number of transactions

"I tend to have more confidence in the most recent transactions and the transactions closest to the subject company. Therefore, I reject this method."

or

Valuation Method		Indication	Weights		Weighted Portion
Transactions - Price to Revenue	$	4,667,227	55%	$	2,566,975
Transactions - Price to SDE	$	505,000	15%	$	75,750
Transactions - Price to EBITDA	$	472,833	10%	$	47,283
Single Period Capitalization	$	155,579	10%	$	15,558
Adjusted Book Value Method	$	227,225	10%	$	22,723
Conclusion of Value				$	2,728,289

Assertion without supporting data

"Using Pratt's Stats we were able to identify sales over the years with similar revenue sales and services throughout the country. We were able to define a sales multiple of 1.5x."

	Completed 2017	Projected 2018
Revenue	$ 1,938,391	$ 2,672,921
Midpoint	$ 2,305,700	
Multiple	1.5	
Indication	$ 3,458,550	
DLOC 25%	$ (864,638)	
Indication	$ 2,593,913	
DLOM 24%	$ (622,539)	
Conclusion of Value	$ 1,971,374	

We Love the Income Approach

- Valuation uses both a capitalization of earnings and DCF methods with inconsistent results
- Let’s capitalize EBITDA with the built-up discount rate
- Using a calculated discount rate as a capitalization rate
- Using weighted averages of the last five years forgetting that depreciation exceeded capital expenditures

Let’s do Average NCF to Invested Capital

	20x5	20x6	20x7	20x8	
Net Income (after tax)	401	525	785	904	
Plus Depreciation	141	210	225	290	217
Less Capital Expenses	(96)	(159)	(214)	(200)	(167)
Less Additions to Net Working Capital	(461)	51	(32)	(184)	
Plus Interest Expense (net of tax)	40	59	67	73	
Net Cash Flow to Invested Capital	25	686	831	883	
Average NCF		606			

Confused Cash Flow

Forecast	20x1	20x2	Terminal Year
EBITDA	$43,273	$82,105	$82,105
PV Factor 11.16%	0.8961	0.8021	/(11.6% - 6% growth)
PV Figure	$38,866	$65,856	$1,446,160
Net Present Value	$1,550,882		

Since the economic benefit is after-tax, the analyst has applied a combined rate of 40% and applied it to the conclusion.

How about growing at 30% forever?

Forecast Period	After Tax Cash Flow	Growth Rate	PV using 17.92% Disc Rate	Discounted Cash Flow
20X1	197,798		0.84804	167,741
20X2	257,137	30%	0.71917	184,925
20X3	334,278	30%	0.60989	203,873
20X4	434,561	30%	0.51721	224,759
20X5	564,930	30%	0.43861	247,784
	Terminal Value		247,784	
	Growth Rate		30%	
	Indication		322,119	
	Cap Rate		0.1792	1,797,540
Indicated Equity Value before Discounts				$2,826,622

We Love Discounts

- Use of a DLOC without controlling adjustments
- Citing restricted stock studies for DLOM of controlling interest
- Citing court cases to support DLOM
- Applying discounts in reconciliation rather than in the method

From J.E.B. Files: Reconciling a Wide Range of Results

METHOD	INDICATION OF VALUE	WEIGHT	RECOMMENDED VALUE
Adjusted Book Value	$ 41,893	0%	$
Capitalization of Earnings	$ 789,351	20%	$ 157,870
Excess Earnings	$ 723,847	50%	$ 361,924
Market Method-Independent Agents	$ 580,793	5%	$ 29,040
Market Method-Allstate Agents	$ 1,216,103	10%	$ 121,610
Termination Value	$ 350,632	15%	$ 52,595
		100%	$ 723,038
Less 10% Marketability Discount			$ (72,304)
			$ 650,735
Recommended Net Value, Rounded			$ 650,000

About as Bad as It Gets

The business valuation report, page 106, presents the following information: (Please note this section of the business valuation report is headed Controlling Interests).

"According to PPC, there is considerable evidence suggesting that the marketability discount for a closely held stock compared with a publicly traded counterpart should average between 35% and 50%, in the absence of special circumstances such as those noted (below) that would tend to reduce the discount for lack of marketability."

The actual language from the PPC book follows:

"There is considerable evidence, however, suggesting that the marketability discount for a minority interest in closely held stock compared with a publicly traded counterpart should average between 25% and 50%, in the absence of special circumstances such as those noted in Exhibit 8-13 that would tend to reduce the discount for lack of marketability."

The report language omits the words “for a minority interest” and uses this paragraph to support a 20% discount for lack of marketability, of a 100% control interest. The report language changes the average discount from 25% to 50% to 35% to 50%. The report cites this information in Chapter 8, Page 21, of the PPC book. The actual language is included in Chapter 8, Page 41, of the PPC book.

It should be noted that the PPC book includes a sample report, of a 100% control interest, in a Company, and does not apply marketability discounts. This information is very misleading and seriously undermines the credibility of the business valuation report.

SUGGESTIONS TO IMPROVE OUR VALUATION PERFORMANCE

- Be very objective and follow the Standards.
- Ask yourself is this the value I would develop if a family member was buying or selling this business?
- Is the work credible?

  Credibility Attributes (from *Determination of Value* by Francisco Rosillo)

    1. Replication
    2. Relevance
    3. Reliability
    4. Reasonable Tests
    5. Generally Accepted Methods and Procedures
    6. Transparency
    7. Adequate Disclosures
    8. Nonadvocacy
    9. Completeness
- Continuing education.
- Report writing course.
- Develop strategies, work processes and analytical checks to ensure data/content quality and produce higher quality reports.