

Ooops (*sic*) ... or how to avoid a visit to the Ethics Committee

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NACVA AND THE CTI'S
2020 Business Valuation and Financial Litigation
VIRTUAL SUPER CONFERENCE



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NACVA AND THE CTI'S

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Our Outline:

1. Whadaya mean someone complained about my report?
2. Ethical lapses
3. How to really demonstrate your incompetence
4. Suggestions to improve our valuation performance



1. Whadaya mean someone complained about my report?



NACVA Certificant Complaint Form

Please complete the following information so that we may properly review and investigate your complaint. The National Association of Certified Valuators and Analysts® (NACVA®) is a highly professional organization, and we view our obligation to our profession, or certificants and the public as being critical to the long-term success of our profession. All matters and names of individuals put before the Ethics Oversight Board (EOB) or the Executive Advisory Board (EAB) shall be kept in strict confidence.

Important Note: The EOB has an obligation to investigate all allegations of potential violation(s) of ethical or professional standards. Once you submit your complaint to the EOB it cannot be withdrawn by either party.

Question Title

Date of Complaint

Question Title

Is this matter/case currently involved in any form of litigation?

If so, this Board cannot consider a complaint until the matter has been resolved. At that time, you may file a complaint, if applicable.

Please describe in detail why you believe this certificant is in violation of NACVA's Professional Standards (We do not investigate fee disputes.). In your description, please identify **specific** problems with the certificant's report (found to be in violation).

Identify which Standards have been violated (for example, 3.7 Valuation Approaches and Methods, 3.11 Capitalization/Discount Rate, 4.3.b.(1) Reporting Standards—Detailed Reports, Non-operating assets and liabilities, etc.). Note: If/When the litigation engagement is subject to discovery and/or cross-examination, NACVA's Reporting Standards do not apply. Click on the following link to refer to [NACVA's Professional Standards](#).

You **must** identify (**mark/label**) the specific page number(s) in the report and/or exhibits, and (highlight/underline) where each violation exists within the report. This level of detail will greatly assist the Board in reviewing your Case and in their investigation of this Complaint (attach file with additional pages below as necessary).

Question Title

Violation detail:

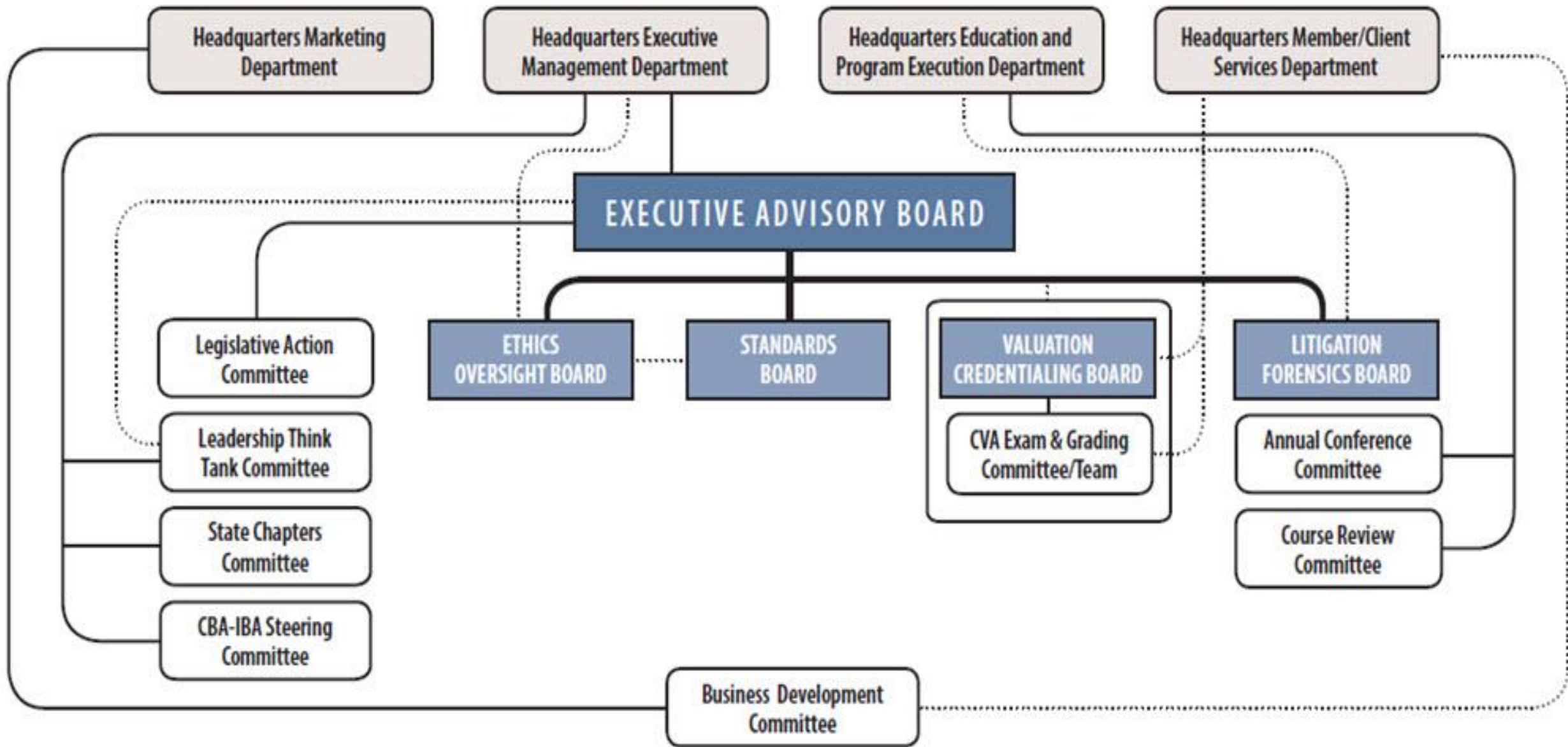
Reference Standard #

Standard Violated

Describe in Detail the Potential Violation of Referenced Standard



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Ethics Oversight Board (EOB)

- The EOB is charged with the monitoring of NACVA's membership and certificants with regards to ethical and professional Standards.
- The EOB's responsibilities include creating policies for educating, monitoring, and enforcing compliance.
- The EOB's duties also include facilitating awareness and enhancing the understanding of NACVA's Standards, and when necessary, investigating and determining whether a member and/or certificant has violated NACVA's Standards.



EOB - POLICIES & PROCEDURES MANUAL (R 6/2018)

- INTRODUCTION 2
- THE STANDARDS MONITORING PROCESS 3
- 1.0 Receipt of Complaint 3
- 2.0 Review of Complaint 3
- 3.0 Investigation 4
- 4.0 Respondent Cooperation 7
- 5.0 EOB Review 7
- 6.0 Subsequent Member Contact 8
- 7.0 Appeals 9
- 8.0 Required Corrective Action Recommendations 9
- 9.0 EAB Authority 10
- 10.0 Document Disposition 10

So, what happens when a complaint is filed?

- Call/letter to NACVA Headquarters
- Liaison to Ethics Oversight Board (EOB) informally investigates
- Refers to EOB who “...is charged with monitoring of NACVA’s membership and certificants with regards to ethical and professional Standards.”
- EOB investigates any violation of NACVA standards
- Determination of violation reviewed by 2 voting members of Valuation Credentialing Board and 2 members of Executive Advisory Board
- Ratify EOB decision (maybe attorney review) or force EOB to revisit
- Appeals directed to NACVA Board



A. INTEGRITY AND OBJECTIVITY

A member shall remain objective, maintain professional integrity, shall not knowingly misrepresent facts, or subrogate judgment to others. The member must not act in a manner that is misleading or fraudulent.



B. PROFESSIONAL COMPETENCE

A member shall only accept engagements the member can reasonably expect to complete with a high degree of professional competence. If a member lacks the knowledge and/or experience to complete such engagements with a high degree of professional competence, the member is not precluded from performing such engagements. In such instance, the member must take steps necessary to gain such expertise through additional research and/or consultation with other professionals believed to have such knowledge and/or experience prior to completion of such engagements.

(Rob's Question: How do we know that we lack competence?)



C. DUE PROFESSIONAL CARE

A member must exercise due professional care in the performance of services, including completing sufficient research and obtaining adequate documentation.



Changes to NAVCA Standards June 1, 2017

2. Development Standards (*footnote references removed*)

- a. Must avoid bias
- b. May rely on information from any source without corroboration if disclosed in report
- c. Members should retain documentation for a sufficient time period to comply with legal regulatory and professional requirements. NACVA recommends a minimum of five years.
- d. Financial statement adjustments, earnings determination, capitalization/discount rate, and market-ability; control and other discounts are no longer specifically listed.



Published on NACVA website (for 3 years):

Various Disciplinary Actions that were active/processed by the Ethics Oversight Board

		Date Complaint Submitted and Case Closed
Member Name	Disciplinary Action Taken	
XXXXXXXXXXXXXX	Required Corrective Action imposed and not completed. We accepted resignation of membership and relinquishment of CVA designation.	1/20/2009 to 1/4/2018



2. 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 calculation 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 or their respective clients – disagree as to essentially every input and assumption contemplated in their DCF calculations.”
- “It is abundantly clear that their valuations are tailored to suit the party who is paying them. This cold fact cuts against both experts’ credibility in equal measure.”



Tax Court comments:

“[The valuator’s] report’s guideline company analysis was even more questionable. It provided no data to support the calculations of... pretax earnings and book value for either the comparable companies or True Oil. ... did not explain the relative weight placed on each factor ... without more data and explanations we cannot rely on XXX report’s valuation conclusions.”

- *True Estate v. Commissioner* (TC Memo 2001-167, *aff’d.*, 390 F. 3rd 1210 (10th Cir. 2004))



Professional Liability Claims?

- “Professional liability claims against CPAs for valuations are not as frequent as claims made against accountants for tax-related services, but valuation-related claims tend to involve larger dollar amounts... the average liability claim for tax services is \$55,000, but it is around \$300,000 for business valuation claims.”
- “Another major claim is the accountant who doesn’t specialize or have a familiarization or track record of performing valuation work and takes on the engagement nonetheless.”

- John Raspante, Director of Risk Management for the North American Professional Liability Insurance Agency, LLC (Sageworks webinar)



3. 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, or 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%. The premium was applied to the initial guideline public company conclusion (about 10x EBITDA), yielding a conclusion of about 17x EBITDA.
- The difference between a final price of \$91 per share and \$60 per share meant about \$200 million in purchase price difference.



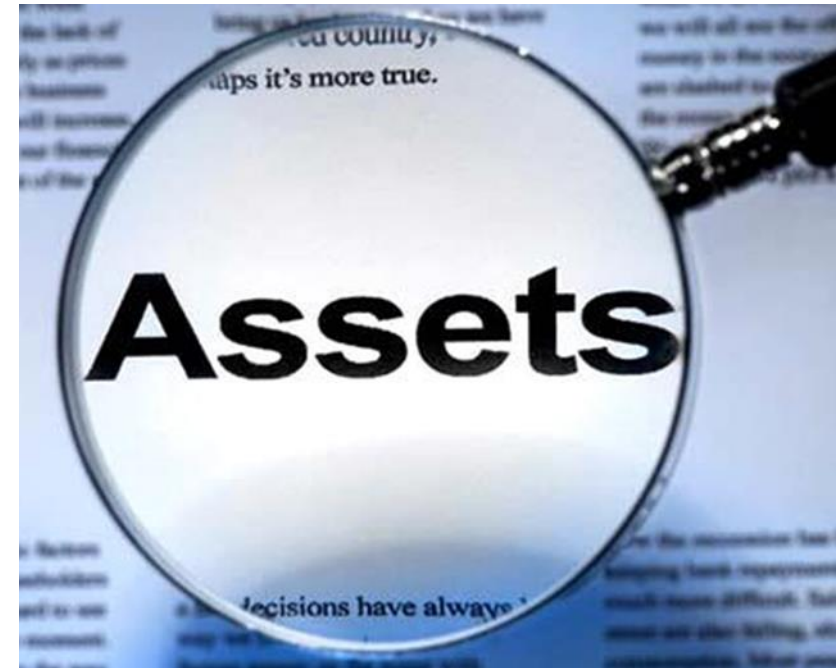
Let's build-up a Discount Rate

- *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 income cap = \$70
- Giving an opinion on fair market value of real estate, machinery and equipment without experience as an asset appraiser
- Ignoring consideration of intangible assets in an operating company (e.g., “Book Value Method”)



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
- Failure to consider yield metrics in selection of revenue multiples



“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
<i>Conclusion of Value:</i>			<u>\$ 2,728,289</u>



Deriving a CAP Rate from two sources:

Derivation of Capitalization Rate

Price to SDE:

IBA Database	4.19x
Deal Stats	4.28x
Median SDE Multiple	4.19x
Related Cap Rate (1/SDEMultiple)	23.90%
Add Specific Company Risk	-2.00%
Adjusted Cap Rate on SDE	21.90%
Calculated Multiple	4.57x



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.”

		<i>Completed</i>	<i>Projected</i>
		<i>2017</i>	<i>2018</i>
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 capitalization expenses



Let's do Average NCF to Invested Capital

Average After-Tax Net Cash Flow to Invested Capital

	20x5	20x6	20x7	20x8	
Net Income (after tax)	401	525	785	904	
Plus Depreciaton	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	
<i>Net Cash Flow to Invested Capital</i>	25	686	831	883	
<i>Average NCF_{IC}</i>	500	606			



Disbungled 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.



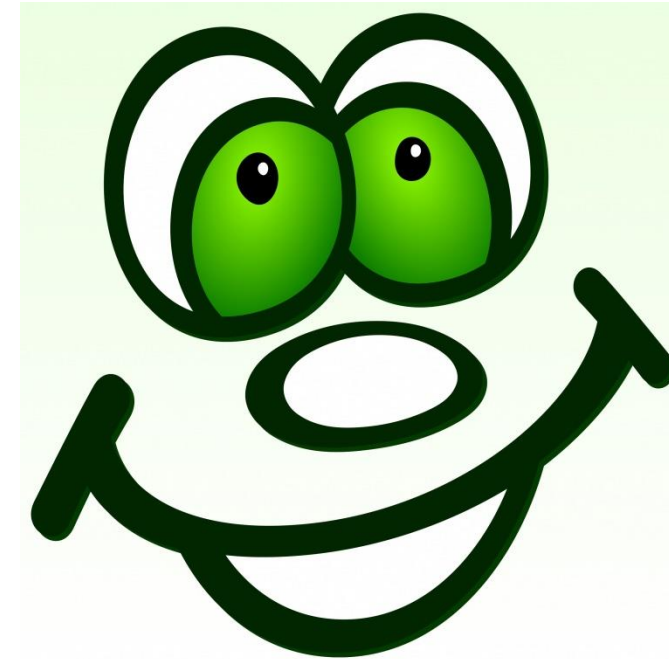
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We decided to use the Capitalized Excess Earnings Method, as we believe that in the case of XXX, this method provides for an adequate approach to value its intangible assets, as it values the earnings capacity of intangible assets as a group. However, as this method is impacted by depreciation, we have included depreciation rate adjustments to more closely reflect estimated economic life.



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
<i>Terminal Value</i>			247,784	
<i>Growth Rate</i>			30%	
<i>Indication</i>			322,119	
<i>Cap Rate</i>			0.1792	1,797,540
<i>Indicated Equity Value before Discounts</i>				\$ 2,826,622



We Love Discounts

- Use of a DLOC without controlling adjustments
- Applying DLOC to minority positions
- Citing restricted stock studies for DLOM of controlling interest
- Citing court cases to support DLOM
- Applying discounts in reconciliation rather than in the method
- *The average control premium observed in the Mergerstat Studies was 35%, so this is what we will use for the subject.*



How to estimate DLOM

According to management as well as the interview with an outside member of the Company's Board, we developed an estimate that approximately 10% of the Company's cash flow could be disproportionately used for the benefit of a controlling owner, relative to minority shareholders. Accordingly, we utilized this 10% factor as a minority discount for the purpose of adjusting the conclusion of value derived in the Market Approach.



4. Suggestions to Improve our Valuation Performance

- Read dialectically – think like an equity buyer
- Proof your calculations and assumptions – are the income & market methods indications widely dissimilar?
- Have the report reviewed by an Administrative person
 - What isn't understood?
 - What doesn't make sense?
- Consider questions that the opposing attorney will likely ask
- Work with your Mentor, and be proud of your work

