

# Business Valuation Notes

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## Getting a Defensible Valuation

### DUE DILIGENCE REQUIRES MORE THAN JUST FINANCIAL STATEMENTS

#### Devil's in the Details...

Analysts must use an engagement letter, questionnaire, and conduct a company visit when preparing a valuation of most companies, according to Minnesota Business Valuation Group President Randall Schostag. The engagement letter sets forth the mutual agreement as to what work and product is expected while the questionnaire begins the process of information gathering.

"The questionnaire is a critical document which provides support, ensuring that the analyst has asked all of the important general questions of a subject company," Schostag said. "We don't want to go to court to defend the value which we've determined, only to learn about company facts after the value is challenged."

"The engagement letter spells out what the analyst will do, how much it will cost, and what is expected from the client. The devil is in the details."

Schostag raised those issues recently in connection with a client who believed that the analyst had sufficient information by virtue of having audited financial statements and access to the auditor.

"Although audited financial statements are preferred for appraising a firm because of their full disclosure," Schostag said, "a financial audit does not offer much in terms of operating information to the analyst, or informa-

tion with regard to intermediate and long term plans of a company. Without this information, the analyst cannot properly evaluate the likely future direction of a business. A valuation, by definition, is mostly concerned about where the company is going rather than where it has been."



Schostag

Although legal statutes differ from country to country and venue to venue, an audit of financial statements is usually required for investment, financing, and tax purposes. These are usually performed by independent accountants or auditing firms. Results of the audit are summarized in an audit report that either provides an unqualified opinion on on attestation issues of the financial statements or qualifications as to its fairness and accuracy.

Complete financial statements provide an overview of a business' financial condition for both short and long term. There are four basic financial statements: the balance sheet, the income statement, the statement of retained earnings, and the statement of cash flows. In the case of holding companies or companies with subsidiaries, the financial statements usually also include disclosure of selected highlights of the income statements and balance sheets of the subsidiaries as well

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## Intangible Assets ....

### APPRAISAL FOUNDATION REQUESTS COMMENTS

#### Using the Excess Earnings Method

The Appraisal Foundation (TAF) has called for comments on its first draft of *Best Practices for Valuations in Financial Reporting: Intangible Asset Working Group*. TAF, authorized by the United States Congress as the source of appraisal standards and appraiser qualifications, issued the discussion draft June 10, 2008, and would like comments by July 22, 2008.

MBVG President Randall Schostag said persons and businesses with intangible assets, especially those contemplating buying, selling, or merging businesses, should review the terms of the draft.

TAF is developing a series of topics relating to valuation practices following numerous changes in financial reporting requirements; MBVG has covered many of those changes in our newsletters with pronouncements by the American Institute of Certified Public Accountants, the Securities & Exchange Commission, and the Financial Accounting Standards Board.

An important TAF output is the Uniform Standards of Professional Appraisal Practice (USPAP). The Financial Institutions Reform, Recovery and Enforcement Act of 1989 recognizes USPAP as the generally accepted appraisal standards and requires USPAP compliance for appraisers in federally

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# TAF

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related transactions. State Appraiser Certification and Licensing Boards; federal, state, and local agencies, appraisal services; and appraisal trade associations require compliance with USPAP. Schostag believes that adoption of the draft will mean its acceptance as a preferred method, though the adoption will not be treated as a standard.

TAF will be addressing additional topics in the pursuit of developing consistent and verifiable valuation practices. The foundation is selecting topics based on those in which the greatest diversity of practice has been observed. This draft treats preferred methods of valuing intangible assets using the Multi-Period Excess Earnings Method (MPEEM).

The MPEEM is a form of discounted cash flow analysis. From a historical perspective, MPEEM has its roots in what has been called the Excess Earnings Method which was first developed when the government shut down distilleries at the onset of prohibition (ARM 34) and was later referred to as the formula approach (US IRS 68-609).

Using the excess earnings method, an analyst first determined the rate of return – or rent – on tangible and cash assets and determined that anything in excess of that return was attributable to other blue sky assets. Using MPEEM the analyst examines the entire cash flow from the enterprise and then deducts those portions of cash flow which are attributable to other assets. In most instances, a single intangible asset is unlikely to be solely responsible for generating cash flow alone, and relies on the use of other assets. If specific revenues and expenses cannot be separated from the revenue and expenses of the intangible asset, then those assets are considered contributory assets and will be included in valuing the assets.

Contributory assets may include

working capital, tangible assets, and / or other intangible assets.

Schostag said that to this point the Statement of Accounting Financial Standard (SFAS) 141, Appendix A and the AICPA toolkit have provided the best counsel for use with purchase price allocation and goodwill impairment, but that the new TAF Best Practices may offer additional good advice for use in those instances.

## CALCULATIONS OF VALUE

### ...When & How

The new valuation standards for Certified Public Accountants include a provision for doing ‘Calculations of Value’ instead of doing a ‘Valuation Engagement’ and have resulted in some confusion.

The issues were summarized in a recent article in *Business Valuation Update*, Vol. 14, No. 6, June 2008, published by BVResources.com in an article entitled: When is it Safe to Perform a Calculation of Value?

The article stems from a roundtable discussion of three seasoned appraisers who participated in a teleconference sponsored by BVResources.

Use of a calculation versus a valuation engagement is of most concern to CPAs or for those who are employed by CPA firms. MBVG is a wholly-owned subsidiary of Olsen-Thielen & Co., Ltd., a regional CPA firm and, therefore, is subject to the Statement of Standards of Valuation Services No. 1 (SSVS 1), professional AICPA standards.

The new standards have been issued to ensure that when CPAs issue valuations that in the case of valuation opinions that full attention is given to proper information gathering, analytical, and presentation procedures. The AICPA wants to ensure that the professional reputation of a CPA designation is not devalued from poor work product. As such, the standards also raise the bar for all appraisers.

During the panel discussion the experts observed that many CPAs seem to be using the term calculation as a way to side-step doing all of the necessary work to develop a defensible value. However, the panelists were uniformly firm that a value developed through a calculation will preclude an appraiser from testifying about the value; the work simply does not comply with the standards.

The panelists recalled situations they have faced with limitations on information, especially prevalent in divorce appraisals. Adding to the panelist discussion, Schostag said that MBVG has completed a couple of recent divorce valuations where information was nearly totally absent. “We changed the scope and limitations on the appraisal, to the mutual agreement of both parties,” Schostag said. “The new scope carefully set forth the difference between a conclusion of value obtained through an engagement and a value produced, but not an opinion, derived from a formulaic approach the parties felt were reasonable.

“We learned in those instances that the parties often hear only what they want to hear. It is critical to keep going back to the parties to ensure understanding and buy-in.”

Another lesson-learned from those MBVG cases is that the term ‘agreed-upon procedures’ has specific meaning to CPAs, and that to ensure that neither the CPA or client misunderstands or misapplies these terms, MBVG avoids that term in the scope. “We do set forth a process, formula, or other ways which will be used to determine a value,” Schostag said. “However, we do not want to confuse anyone about our terms relative to existing CPA conventions.”

One of the panelists has created a CYA report, short for Cover Your Assets, wherein the appraiser will invest four or five hours, reviewing basic documentation available to ascertain if there is enough to do a business valuation.

“MBVG does not want to undertake a valuation only to discover that its work can’t be used in court,” Schostag said.

# Questionnaire

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as parent company adjustments.

Full disclosure financial statements contain an extensive set of notes following the financial summaries to explain entries in more detail. These notes to financial statements are very useful to appraisers, and are used to better understand past operational performance and financial condition.

However, the financial notes to financial statements, even when present, do not include important operating information, such as officers and board members, specific duties and compensation of employees, key competitors and market position, specific product lines, internally developed proprietary processes and products, critical vendors, marketing systems, important research and development, buy-sell agreements, number and turnover of employees, key-person insurance, vendor and customer contracts, employee contracts and confidentiality agreements, and many other factors.

“Audited and reviewed financial statements are very nice to have when available,” Schostag said. “For those which are only prepared internally by a company and are not compiled, reviewed or audited, the analyst must spend much more time trying to ascertain what the business performance might look like if the statements conformed to generally accepted accounting principles and if the reported information is accurate, as it has not been subject to audit.”

Rick Ehrich, CPA and MBVG's Treasurer, is a Principal in the Accounting and Auditing Department of the St. Paul Office of Olsen Thielen and oversees practice review for quality assurance. His preference is that analysts use checklists to ensure necessary information has been obtained. Schostag said such checklists are available from various sources, including *Practitioners Publishing Company, Guide to Business Valuations* to assist in compliance with report preparation.



**Ehrich**

MBVG's use of checklists is generally informal and those lists are not normally part of the permanent file, according to Schostag. However, each analyst must examine the final report and findings, reviewing information obtained to assure relevant questions have been asked and answered. Adherence to good information gathering is integral to a final release of the report, according to Schostag, who reviews all finished reports before client delivery.

Schostag is certified for appraisal by the American Society of Appraisers, the Institute of Business Appraisers, and the National Association of Certified Valuation Analysts. All of these organizations and the American Institute of Certified Public Accounts also has standards which must be complied with.

“After the engagement is defined in the engagement letter, the questionnaire is only a beginning point,” Schostag said. “Once received, it will usually raise additional questions which must be answered by the client, and more detail will be needed.

“For example, the questionnaire requires that officer compensation is set forth along with shareholder ownership. The compensation and ownership in some instances may suggest that compensation should be adjusted to reflect an appropriate amount for a given position to replace that officer and which may, therefore, adjust net income as reported in the financial statements.”

Other adjustments which require information beyond the reported financial statements may include expected future capital outlays and financing sources for those outlays and which would impact estimated future cash flows.

“Part of the reason MBVG remains loose with respect to checklists is because each valuation becomes very specific to each client,” Schostag said.

“Many of the available checklists are minimal in outlining nonfinancial, operating information gathering. To understand a business and thus estimate future cash flows necessitates a solid understanding of the business operations. Therefore, in addition to the initial questionnaire, MBVG will usually require a

company visit and follow up questions of a key person within the company.”

PPC, for example, specifically recommends that analysts “...be aware of other operational data and contracts that may obviously affect value.” (402.35, *PPC, Guide to Business Valuations*.) These include but are not limited to: management team, stockholder and director lists, officers and directors compensation, key man life insurance, organization charts, business plans, brochures, price lists, catalogues, and other product information, sales forecasts, customer and supplier data, capital budgets, major competitors, specific asset appraisals, other consultant reports, auditor and accountant reports, details on transactions in the company stock, offers received for the company, and details of offerings for debt or equity.

As noted in PPC, the valuation begins with an engagement letter which sets forth the scope and limitations of a valuation engagement. Within the engagement letter the appraiser will also define preliminary information required by the client which is critical to a defensible valuation and which will also govern when reports can be delivered.

“Without the information or with information which is requested but not received, the final value may vary considerably from what it should be and will likely not be robust and defensible,” Schostag said. “MBVG's engagement shifts this potential liability to the client because the client's cooperation is absolutely necessary to obtain a correct value.”

The engagement letter describes what will be valued, such as common stock for a controlling interest or a minority interest, options, warrants, debt, intangible assets, real estate, or other items. The letter cites the purpose of the valuation, such as for merger / acquisition, ESOP implementation, purchase price allocation, built-in gains, executive compensation, etc. The letter also sets forth an effective date.

“MBVG also spells out pricing for the service in the engagement letter, including terms of payment,” Schostag added.

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## Professional Business Appraisals

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#### **BUSINESS VALUATION**

Goodwill Impairment Analysis (141/142)

Businesses

Intellectual Property

Intangible Assets

Options

Strategic Planning

ESOP

Divorce

Shareholder Oppression / Dissenting Rights

Buy/Sell Agreements

Merger / Acquisitions

Fairness Opinions /Purchase Allocation

Planning

#### **BUSINESS ASSET VALUATION**

Experts or Consultants

Sale / Purchase

Insurance

Fair Rental Rates

Financing

Ad Valorem Taxes

Condemnation

Feasibility

Purchase Price Allocation

Property Records

Fiduciary Review

Sale / Leaseback Structuring

Business Planning

**WE ARE AVAILABLE FOR PRESENTATIONS FOR ESOP IMPLEMENTATION,  
MERGER & ACQUISITION CONSIDERATIONS, EXPERT TESTIMONY PREPARATION,  
GENERAL BUSINESS VALUATION, AND MANY OTHER TOPICS.**

**OUR FORMAT IS POWER POINT - BASED.**

**WE REQUEST THAT YOU SUPPLY THE SOUND SYSTEM AND APPROPRIATE DISPLAY  
INSTRUMENT.**

**WE WILL CONNECT OUR COMPUTER.**

**PLEASE ALLOW AT LEAST 30 DAYS FOR SCHEDULING.**