# 100 Introduction

**What Is a Closely Held Business?**

100.1 The valuation methods discussed in this *Guide* focus on valuing closely held businesses. The authors use the term *closely held business* to refer to a business that is owned by relatively few stockholders (or partners) and is not publicly held, i.e., not traded on a national or local stock exchange or in the over-the-counter market.

100.2 **How Does Size Affect the Definition?**

There is a natural inclination when one hears the term *closely held business* to envision a relatively small company when measured in terms of total revenue or total assets. However, a closely held business can range in size from a relatively small corner business to an extremely large, complex entity with sales in excess of $1 billion. Again, the common denominator of this wide size range of companies is that they are owned by a relatively small number of stockholders (or partners), and their stock is not publicly traded.

100.3 **Does the Approach Used to Value a Publicly Traded Company Differ?**

The honest answer to this question is no. The methodology used to value a publicly held company follows very closely that used to value a closely held company. In fact, valuation consultants who value publicly held companies, or financial vice-presidents, controllers, and accountants involved with the merger/acquisition activities of a public company, will find the guidance presented in this book very helpful. However, despite the similarity in approaches, a number of practical considerations or distinctions should be considered in valuing a closely held company. Those distinctions are as follows:

a. *Emphasis on Earnings versus Other Benefits.* Closely held companies are often managed directly by their shareholders, whereas publicly traded companies are usually not. A primary goal of management of a public company is to maximize the wealth of the company's shareholders through the payment of dividends or through capital appreciation. Earnings per share is a commonly used standard by which to evaluate the success of a public company's management. The owner/operators of private companies, however, can often maximize their benefits through salaries and other perquisites without regard to earnings, although earnings are still important to bankers, outside shareholders, and other third parties. For privately held companies, the primary emphasis is usually on net cash flow to the owners rather than net income.

b. *Quality and Availability of Financial Information.* Because publicly held companies are required by the Securities and Exchange Commission (SEC) to file periodic financial statements, there is a readily available data base of audited financial information that can be used to assist in arriving at value. Such a reliable and sophisticated data base does not exist for closely held companies. Consequently, the valuation consultant who deals with closely held companies often encounters situations where there is a lack of formal financial statements, or where numerous analytical tests must be performed to establish the reasonableness of financial information.

c. *Requirement for Specialized Knowledge.* The ability to value a public company often requires a knowledge of foreign operations (laws, economic conditions, etc.), a very large valuation staff, a diverse expertise in a variety of industries, and some knowledge of securities laws. In reality, such an engagement may be beyond the scope of the typical valuation consultant whose experience is primarily with small to medium-size companies. However, if a private company is a candidate to be sold to a public company, some understanding of the public company perspective is necessary.

**What Is a Valuation Engagement?**

100.4 A valuation engagement involves arriving at an opinion regarding the estimated value of an ownership interest in a business entity (company) as of a given point in time. The ownership interest valued may be the company's common equity or its total capital, which includes both interest-bearing debt and equity.

100.5 **Reasons for Valuation**

Business valuations are performed for a variety of reasons, including the following:

a. Selling all or a partial interest of a business.

b. Buying all or a partial interest of a business.

c. Mergers.

d. Corporate or partnership dissolution or recapitalization.

e. Divorce.

f. Buy-sell agreements.

g. Gift, estate, inheritance, and income taxes.

h. Charitable contributions.

i. Estate planning.

j. Determining the need for life insurance.

k. Obtaining financing.

l. Preparing personal financial statements.

m. Employee Stock Ownership Plans (ESOPs).

n. Determining damages:

(1) Breach of contract suits.

(2) Antitrust suits.

(3) Lender liability suits.

(4) Condemnation (eminent domain).

(5) Lost business opportunity.

(6) Business interruption.

o. Allocation of total value:

(1) Among classes of ownership interests.

(2) Among classes of assets.

p. Ad valorem taxes (property taxes).

q. Dissenting stockholder and shareholder oppression suits (and other stockholder disputes).

r. Financial reporting.

(1) Measuring identifiable assets acquired (including research and development assets and intangible assets), liabilities assumed, goodwill, and any noncontrolling interest

resulting from a business combination.

(2) Asset impairment analysis, including goodwill and acquired research and development assets.

(3) Stock options.

100.6 As discussed in item r., valuation engagements can be performed to assist companies and their auditors in complying with the FASB's increased reliance on fair value reporting. For example, FASB ASC 820, *Fair Value Measurement*, provides a framework for measuring fair value in GAAP and modifies disclosures about fair value measurement, and FASB ASC 825, *Financial Instruments*, permits entities to choose to measure many financial instruments and certain other items at fair value. Also, FASB ASC 805, *Business Combinations*, and FASB ASC 350, *Intangibles—Goodwill and Other*, require most assets and liabilities to be recorded at fair value during the initial business combination and subsequent impairment reviews. FASB ASC 820 and FASB ASC 825 are discussed further beginning at paragraph and 201.8, and FASB ASC 805 and FASB ASC 350 are discussed beginning at paragraph 704.8.

100.7 **Scope of Service**

In responding to a client's needs, the valuation professional may prepare anything from an oral discussion of reasonable ranges of value to a comprehensive, fully documented written report that would be defensible in court.

### For Whom Is This *Guide* Written?

100.8 This *Guide* is written for a broad audience, including the CPA practitioner, the professional valuation consultant who provides valuation services to the public, and the attorney who deals with a variety of valuation cases. However, the methodology and approaches discussed in this book can be adopted or adapted by a wide range of other users. For example, the accountant in industry who is involved with mergers or acquisitions, buy-sell agreements, etc., will find this *Guide* very helpful. In addition, bankers, business brokers, and others who deal with a variety of valuation issues will find that the book contains practical, easy to understand discussions of valuation techniques.

### How the *Guide* Is Organized

100.9 This *Guide* approaches valuation services from two primary viewpoints. First, the service is approached from the quality control engagement viewpoint, i.e., the logical sequence of steps (from the initiation of the engagement to the issuance of the written or oral valuation report) necessary to deliver a quality service. Second, the *Guide* provides guidance on how businesses are actually valued. It contains numerous examples of valuation techniques and methods along with guidance on how to select the appropriate method for each unique circumstance.

### 100.10 **Glossary of Valuation Terms**

A glossary of common valuation terms is included at Appendix 2A. The definitions are provided to assist the valuation consultant in understanding valuation terminology and in explaining these terms to the users of the valuation.

### 100.11 **Notation System**

Appendix 2D presents a notation system presented in *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*; Fifth Edition, by Shannon P. Pratt, with Alina V. Niculita. This notation system is included in this *Guide* to offer a common notation system for the business valuation community. However, other notations may be used, if desired.

END OF DOCUMENT -

# 101 The Role of the Consultant in a Business Valuation Engagement

**The Role of Objectivity and Independence in a Valuation Engagement**

101.1 Regardless of the background of the consultant or the unique requirements of his or her profession, one of the most critical professional and ethical decisions the valuation consultant must make involves the issue of objectivity. On any engagement, a valuation consultant must assume one of the following roles:

a. The consultant serves as an independent consultant, performing an objective valuation of the company (or a specific interest in the company), or

b. The consultant serves as an advisor, determining and negotiating a value that is most beneficial to the client's position.

The consultant must define his or her role before beginning an engagement and should clearly communicate that role to the client in a signed engagement letter.

101.2 **There Is Normally a Presumption of Objectivity**

Just as an auditor is presumed to be independent with respect to an audit client, a consultant is normally presumed to be independent and objective with respect to a business valuation. The AICPA's revised *Code of Professional Conduct* (revised Code) states the following:

> **ET 1.100—Integrity and objectivity.** In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.

101.3 The AICPA Statement on Standards for Valuation Services (SSVS) No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset*, further states in paragraph 14 (VS 100.14):

> Objectivity is a state of mind. The principle of objectivity imposes the obligation to be impartial, intellectually honest, disinterested, and free from conflicts of interest. If necessary, where a potential conflict of interest may exist, a valuation analyst should make the disclosures and obtain consent as required under Interpretation No. 102-2. . . . [ET 1.110 of the revised Code]

Although ET 1.100 and SSVS No. 1 relate specifically to CPAs, the concept of objectivity is important to any consultant who performs valuation services.

101.4 In performing an independent valuation of a company, a consultant should objectively interpret accumulated data in a reasonable and accurate manner. The consultant's opinion of value should not be compromised by external factors such as the wishes of the client or the amount of the fee. In the absence of any disclosure to the contrary, the appraised value of a company is presumed to represent the impartial, unbiased judgment of the appraiser.

101.5 **Protecting the Appearance of Objectivity**

In addition to being objective in providing valuation services, the consultant needs to maintain the *appearance* of objectivity. The consultant's professional reputation can be irreparably harmed whenever an actual or apparent compromise of objectivity or integrity occurs. The following practices should be considered in order to maintain the appearance of objectivity:

a. The consultant should be independent of the company being valued, i.e., there should be no ownership or other financial interest or family relationship.

b. Contingent fee arrangements, whereby the amount of the consultant's fee is based in whole or in part on the outcome of the valuation engagement, must be avoided. Instead, the consultant should price his or her services based on standard hourly or per diem rates or agree on a fixed sum before beginning the project.

c. Progress bills should be rendered and collected in a timely manner as the project progresses. This will reduce a client's ability to exert undue influence on the outcome of the valuation engagement by threatening to withhold payments unless the value is either raised or lowered.

101.6 **Objectivity of Consultants Who Perform Litigation Support Services**

Valuation consultants are frequently engaged to perform appraisals to assist in the resolution of civil or tax disputes. In fact, it is not unusual for both the plaintiff and the defendant in a lawsuit to engage valuation consultants as expert witnesses. It is important to stress the importance of objectivity when providing expert witness testimony in legal disputes. In a litigation engagement, it is especially important to render and collect progress bills regularly to keep the opposing side from trying to imply that the outcome of the engagement may affect the fee.

101.7 **Independence**

As discussed in paragraph 101.2, a consultant is normally presumed to be independent and objective with respect to a valuation engagement. The Professional Ethics Executive Committee (PEEC) issued a Conceptual Framework for AICPA Independence Standards (Conceptual Framework) (ET 1.210) which describes the risk-based approach used by PEEC to determine whether a member's relationship with a client poses an unacceptable risk to the member's independence.

101.8 In situations where there are no independence interpretations or rules that address an accountant's particular independence circumstance, CPAs must refer to the risk-based approach described in the Conceptual Framework Interpretation to evaluate whether the particular independence situation would lead a reasonable person who is aware of all of the facts to conclude that the CPA is not independent.

101.9 The Introduction to the Conceptual Framework indicates that under a risk-based approach to analyzing independence, a member's relationship with a client is evaluated to determine whether it poses an unacceptable risk to the member's independence. Risk is unacceptable if the relationship would compromise (or would be perceived as compromising) the member's professional judgment when rendering an attest service to the client.

101.10 The Conceptual Framework discusses factors that influence independence risk and categorizes these factors as either threats or safeguards to independence. Threats to independence are circumstances that could impair independence. Many individual circumstances (or combinations of circumstances) can create threats to independence. Some examples include the following:

- *Self-review Threat.* Reviewing your own nonattest work, or that of your team, as part of the attest engagement.

- *Familiarity Threat.* Accountants who have close or longstanding relationships with attest clients.

- *Undue Influence Threat.* Attempts by an attest client's management to exercise influence over the CPA, such as pressure to reduce audit procedures for the purpose of reducing audit fees.

• *Management Participation Threat.* Performing management functions on behalf of an attest client, such as making hiring decisions.

101.11 Safeguards are controls that eliminate or reduce threats to independence to an acceptable level. Safeguards are generally created or implemented by (a) the CPA profession, legislation, or regulation through continuing education requirements on independence and ethics and external review of a firm's quality control system, (b) the attest client through an attitude that emphasizes its commitment to fair and ethical policies and procedures, and (c) the CPA through rotation of senior personnel assigned to the attest engagement team and the involvement of another firm to perform part of an audit.

101.12 When threats to independence are not at an acceptable level and safeguards are required, the CPA should document the identified threats to independence and the safeguards applied to eliminate the threats or reduce them to an acceptable level.

101.13 Independence and Nonattest Services.

ET 1.295, *Nonattest Services*, covers the practitioner's responsibilities for maintaining independence when providing nonattest services, including valuation services, to attest clients. [1] Note that this guidance is based on the independence of the firm when providing attest services. However, paragraph 15 of SSVS No. 1 (VS 100.15) also states that the requirements of ET 1.295 should be met to avoid impairing independence of the valuation analyst.

101.14 ET 1.295 provides that a CPA's independence would be impaired if he performs an appraisal, valuation, or actuarial service for an attest client that involves a *significant degree of subjectivity* and is material, individually or in the aggregate, to the client's financial statements. Thus, most valuations for business acquisition or sale purposes would violate the CPA's independence rule and preclude the CPA valuator from performing audit or review services for the valuation client. However, business valuations performed for nonfinancial statement purposes, such as valuations for estate and gift tax planning or divorce proceedings, may not impair the CPA valuator's independence.

101.15 If a valuation engagement does not involve a significant degree of subjectivity or is not material, individually or in the aggregate, to the client's financial statements, to comply with the requirements of ET 1.295, a CPA must obtain a written understanding with the client regarding the following:

a. Objectives of the valuation.

b. Services to be performed.

c. Client's acceptance of its responsibilities.

d. CPA's responsibilities.

e. Any limitations of the engagement.

The client's responsibilities noted in item c. include (a) assuming all management responsibilities, (b) overseeing the valuation by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience, (c) evaluating the adequacy and results of the services performed, and (d) accepting responsibility for the results of the valuation. In cases where the client is unable or unwilling to assume all of these responsibilities, the practitioner's performance of the valuation services would impair independence.

101.16 In the authors' opinion, performing valuations for attest clients while remaining independent for the attest work is very difficult. Valuation engagements are, by their very nature, subjective and require numerous judgments to be made by the appraiser. In addition, the client's responsibilities as documented in paragraph 101.15 (such as evaluating the adequacy and results of the services, and accepting responsibility for the results of the valuation) are often difficult for the client to achieve. Thus, CPAs deciding whether to perform valuation services for an attest client should carefully consider all of the requirements of this guidance before accepting the engagement.

101.17 ET 1.295 does not specify how the written understanding is to be documented, so the practitioner has flexibility. For example, the understanding might be documented in a separate engagement letter, or in the workpapers, or it might be included in an engagement letter obtained in conjunction with an attest engagement. See Appendix 1A-5 for further discussion of ET 1.295.

**Advisory Engagements**

101.18 As previously discussed, a valuation consultant should normally perform valuation engagements in an objective, impartial manner. This is not to say, however, that a valuation consultant should never serve as an advisor to a client. Consultants often assist buyers and sellers of companies throughout the negotiation process. In this role, the consultant will typically assist the buyer or seller in establishing a range of acceptable values. The buyer will then usually offer an amount at the lower end of the range while the seller will hold out for an amount closer to the upper end of the range. The consultant can provide invaluable assistance by actively participating in the negotiations, pointing out factors that should lower the seller's expectations or raise the buyer's offering price.

101.19 Some clients believe that whenever they hire a consultant to perform a business valuation, they are hiring an advisor who will support the client's best interests and render a value acceptable to the client. The consultant must ensure that the client is aware of the distinction between an objective appraisal and an advisory service before accepting the engagement. The role of the consultant should be specifically addressed in the engagement letter.

**Other Professional Standards**

101.20 In addition to the general issues of objectivity and independence, valuation consultants must comply with certain additional professional standards. The remainder of this section summarizes the unique standards that may apply in a valuation engagement. More detailed information about these standards is included at Appendix 1A.

101.21 **Standards of the American Institute of Certified Public Accountants (AICPA)**

The AICPA's Statement on Standards for Valuation Services (SSVS No. 1), *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset*, is similar to the standards of other business valuation organizations. For example, the Statement upholds the "known or knowable" concept as of the valuation date. The Statement is also supportive of the three primary valuation approaches: the income approach, the market approach, and the asset-based approach. Valuation approaches and methods unique to valuation of intangible assets are separately identified in the Standards. However, there are slight terminology differences particular to the CPA profession. For example, instead of an appraiser's *certification*, the Standard uses the term appraiser's *representation*. The difference in terms is necessary because the term *certification* holds a unique financial statement meaning to a CPA that is different than the type of certification presented by other business valuation standards.

101.22 The Statement allows for two types of engagements to estimate value—a valuation engagement and a calculation engagement. The valuation engagement results in a *conclusion of value* while the calculation engagement results in a *calculated value*. The estimate of value computed under either analysis may be expressed as an individual number or as a range. SSVS No. 1 also provides guidance for writing the valuation report, including suggested wording for the assumptions and limiting conditions and the conclusion paragraph of both types of engagements. SSVS No. 1 allows oral reports as long as certain reporting requirements are properly communicated to the client and properly documented in the workpapers. SSVS No. 1 is reproduced at Appendix 1A-1. Also, see Appendix 1B-1 for an article comparing the requirements of USPAP to the requirements of SSVS No. 1 and Appendix 1B-2 for a comparison of the requirements of SSVS No. 1 to those of other major valuation standards.

101.23 Nonauthoritative Questions and Answers.

The AICPA Forensic and Valuation Services Executive Committee (FVSEC), a senior committee reporting directly to the AICPA Board of Directors (Board), has the ability to set forensic accounting and valuation services standards without prior clearance of the Board or the AICPA governing Council. The FVSEC issued nonauthoritative questions and answers on practice issues, clarifying the following business valuation-related matters:

- If the CPA valuation analyst uses the subject company's general ledger and prepares financial statements that are used as part of the business valuation report, the CPA (or firm) must prepare and report on the financial statements following the Statements on Standards for Accounting and Review Services (SSARS) (AR 80, *Compilation of Financial Statements*). [2]

- Normalization or control adjustments applied to the subject company's financial statements that were previously audited, reviewed, compiled, or internally generated by the subject company are not subject to the preparation and reporting requirements of AR 80. Such adjustments are considered pro forma adjustments, transforming the “financial statements” into pro forma financial information subject to the requirements of AR 120, *Compilation of Pro Forma Financial Information*. AR 120 does not require a report on pro forma financial information unless the CPA (or firm) has been separately engaged to report on compiled pro forma information. (See paragraph 902.30 for further discussion of a CPA's reporting responsibilities for normalized financial statements.)

- If the CPA valuation analyst uses and makes adjustments to the subject company's tax return information, the CPA (or firm) is not subject to the preparation and reporting requirements of AR 80. Adjustments to tax return information are also considered pro forma adjustments, so there are no reporting requirements.

101.24 After the issuance of SSVS No. 1 (VS 100), the AICPA's Business Valuation Committee, which is overseen by FVSEC, established the AICPA Valuation Standards Subcommittee (VSS). The VSS was established to monitor the business valuation environment for necessary changes to SSVS No. 1, to recommend new topics for potential future standards, and to provide implementation guidance for SSVS No. 1 and any future Standards. As for providing implementation guidance, the VSS established presentation materials and training courses, wrote magazine articles, and responded to specific questions from practitioners. Some of the questions that have been non-authoritatively answered by the VSS are as follows: [3]

- Are fairness opinions covered by SSVS No. 1? No. Because no conclusion of value is offered in a fairness opinion, SSVS No. 1 does not apply.

- Are solvency opinions subject to SSVS No. 1? It depends. SSVS No. 1 does not apply when a CPA is retained to complete the solvency analysis and issue a solvency opinion, even if the CPA performs some valuation-related work as part of the analysis. However, if the CPA is retained as a valuation analyst to perform a valuation analysis and issue a valuation opinion, the CPA must follow the requirements of SSVS No. 1.

- Is an engagement to only provide an estimate of a valuation discount or control premium subject to SSVS No. 1? No, SSVS No. 1 does not apply because the valuation analyst is not providing a conclusion of value or a calculated value.

• Are critiques of opposing expert's valuations subject to SSVS No. 1? Generally, no. If the CPA performs a review and critique engagement, even a review appraisal under USPAP Standards Rule 3, and does not reach an independent valuation conclusion, then SSVS No. 1 does not apply. Thus, the CPA may critique and correct the opposing expert's analysis (sources, research, approaches and methods, mathematics, logic, etc.) and indicate the corrected values. However, if the CPA also concludes that the corrected values represent the CPA's value conclusion, SSVS No. 1 would apply. The same logic applies if the CPA is serving as a trier of fact in litigation matters, such as serving as an arbitrator.

• Are executive compensation "valuations" covered by SSVS No. 1? No. Because there is no engagement to value a business, an interest in a business, a security, or an intangible asset, SSVS No. 1 does not apply.

• Is the determination of an owned undivided interest in real estate covered by SSVS No. 1? No, because there is no engagement to value.

• Is the preparation of an intangible asset royalty analysis subject to SSVS No. 1? No, SSVS No. 1 does not apply because the valuation analyst is not preparing a conclusion of value.

101.25 <u>Recent Actions of the FVSEC</u>.

In addition to issuing authoritative and nonauthoritative business valuation and forensic accounting guidance, the FVSEC also monitors and comments on the business valuation standards of other business valuation organizations. In 2014, the FVSEC was involved in the following areas particular to valuation services:

a. Sent a comment letter to the Appraisal Standards Board (ASB) concerning the following proposed changes to the 2016-2017 edition of the Uniform Standards of Professional Appraisal Practice (USPAP):

(1) Preliminary communications and related workfile requirements of appraisers and

(2) Linking preliminary work and communications to the Ethics Rule.

b. Sent a comment letter to The Appraisal Foundation concerning the December 15, 2013 exposure draft, *The Valuation of Customer Related Assets (“VCRA”)*. The comment letter addressed several issues, such as changing certain terminology, determining when the cost approach would be appropriate, and expanding the section on deferred revenue.

c. Sent a comment letter to the International Valuation Standards Council (IVSC) concerning the exposure draft, *Illustrative Examples Chapter 1—Bases of Value*. The overall concern was the inconsistent terminology between the International Valuation Standards (IVS) Framework, the International Financial Reporting Standards (IFRS), U.S. Generally Accepted Accounting Principles (GAAP), and the International Glossary of Business Valuation Terms. The primary terminology differences included Fair Value, Market Value, Fair Market Value, Market Participants, Willing Buyer/Willing Seller, Arm's Length, Proper Marketing, Exit Price, Entrance Price, Special Value, and Value in Use.

d. Presented the AICPA's view on global valuation standards at the annual meeting of the IVSC, which is responsible for the IVS. During the meeting, several valuation organizations signed a memorandum of understanding (MOU) agreeing to work together towards one set of global standards. These organizations included the American Society of Appraisers, the Canadian Institute of Chartered Business Valuators, the Appraisal Institute of Canada, and the Royal Institute of Chartered Surveyors. Although the AICPA stated that it considers a global, consistent valuation standard is worth pursuing, the AICPA declined to sign the MOU for the following reasons:

(1) All signees agreed to accept the IVS's definitions (see item c.), including the new definition of *fair value*, which is not consistent with GAAP or IFRS.

(2) Its reluctance to have one set of valuation standards for all types of assets, including businesses.

(3) Its belief that professional organizations like the AICPA “should own its professional standards.”

101.26 Other AICPA Nonauthoritative Guidance for Business Valuation.

Over the last several years, the AICPA has issued other non-authoritative guidance related to business valuation. The resource highlights section of the of the AICPA Forensic and Valuation Services (FVS) resources webpage at **www.aicpa.org/interestareas/forensicandvaluation/resources/pages/default.aspx** includes the following publications:

- Valuation of Privately-Held-Company Equity Securities Issued as Compensation—Accounting and Valuation Guide (2013)

- Testing Goodwill for Impairment—Accounting and Valuation Guide (2013)

- Assets Acquired to Be Used in Research and Development Activities—Accounting and Valuation Guide (2013)

- Valuation and Transactional Issues Associated with Employee Stock Ownership Plans—White Paper (2013)

- Intangible Asset Valuation Cost Approach Methods and Procedures—White Paper (2014)

Note that most AICPA white papers are available for free, but other white papers and selected other publications are only free to FVS subscribers. The Accounting and Valuation Guides are available for purchase only.

101.27 Other AICPA Standards that Apply to All CPAs.

The AICPA has established other professional standards that generally apply to all services provided by CPAs. Some of the AICPA standards relate to business valuation engagements and others do not. For example, standards on attestation engagements are normally not applicable because of the nature of a valuation engagement. Other standards, such as those relating to forecasts and projections and those relating to reports on historical financial statements, may or may not be applicable to a particular valuation engagement depending on the type of information contained in the valuation report. Appendix 1A-5 contains a discussion of the following AICPA standards that may apply to CPAs who perform valuation services:

a. Standards That Apply to All Valuation Engagements.

(1) Standards for Consulting Services.

(2) Standards of Professional Conduct.

b. Standards That May Apply to Valuation Engagements, Depending on the Circumstances.

(1) Standards on Reporting on Historical Financial Information.

(2) Quality Control Standards.

101.28 The AICPA Consulting Services Special Report (CSSR) 03-1, *Litigation Services and Applicable Professional Standards*, includes business valuations as a type of service included under the definition of "litigation services." CSSR 03-1 is available from the AICPA at **www.cpa2biz.com**.

101.29 **Uniform Standards of Professional Appraisal Practice of the Appraisal Foundation**

In 1987, nine professional appraisal organizations formed The Appraisal Foundation, which in turn established the Appraisal Standards Board (ASB) and the Appraiser Qualifications Board (AQB). The Foundation, through its Appraisal Standards Board, has developed *Uniform Standards of Professional Appraisal Practice* (USPAP). Standards 9 and 10 relate specifically to performing and reporting on business valuation engagements. Various federal and state regulatory agencies (including the Federal Deposit Insurance Corporation and the Office of Thrift Supervision) have adopted guidelines that require adherence to USPAP.

101.30 USPAP consists of five sections: Definitions, Preamble, Rules, Standards and Standards Rules, and Statements on Appraisal Standards. USPAP Definitions are included at the beginning so the reader has a clear understanding of the multitude of terms used in the document. The Preamble expresses the goal of the document which is to promote and maintain a high level of public trust in appraisal practice by establishing requirements for appraisers. USPAP contains four overarching

Rules covering ethics, competency, scope of work, and jurisdictional exception. Each Rule applies to all appraisal disciplines and set the framework for the conduct of the assignment. The ten Standards and Standards Rules establish requirements for appraisal, appraisal review, appraisal consulting service, and the manner in which each is communicated. One group establishes requirements for the development of an opinion while the other group establishes requirements for the manner in which the opinion is communicated. Statements on Appraisal Standards (Statements) are issued for the purpose of clarification, interpretation, explanation or elaboration of USPAP. They have the full weight of a Standards Rule. Each statement is labeled as to its applicability to the various appraisal disciplines. Currently, there are ten Statements, of which five are retired. Of the remaining Statements, only Statement 9 (concerning the identification of Intended Use and Intended Users) is applicable to business valuation.

101.31 USPAP also includes guidance in the form of Advisory Opinions (AO) to illustrate the applicability of USPAP in specific situations for the resolution of appraisal issues and problems. Guidance provided in AOs does not establish new standards or interpret existing standards. There have been 32 advisory opinions issued of which 5 have been retired. Like the Statement on Appraisal Standards, each opinion is labeled as to its applicability to the various disciplines. Of the 27 active AOs, only nine are applicable to business valuation as they are applicable to all appraisal disciplines. They appear in bold in Exhibit 1-1. The ASB also publishes monthly questions and answers concerning USPAP, which are compiled in its “USPAP Q&A” located at **www.appraisalfoundation.org**.

101.32 The authors believe that USPAP reflects good appraisal practice and recommend that all appraisers comply with it. However, only members of the ASA are bound to comply. Copies of these standards may be ordered directly from The Appraisal Foundation at the following phone number and website:

The Appraisal Foundation
(800) 348-2831
**www.appraisalfoundation.org**

Cost for a complete set of the USPAP is $60. Exhibit 1-1 lists the USPAP standards, Statements on Appraisal Standards, and related Advisory Opinions.

**Exhibit 1-1**

**2014-2015 Uniform Standards of Professional Appraisal Practice**

**INTRODUCTION**

**STANDARDS AND STANDARDS RULES**

Standard 1—Real Property Appraisal, Development
Standard 2—Real Property Appraisal, Reporting
Standard 3—Real Property and Personal Property Appraisal Review, Development, and Reporting

| | |
|---|---|
| | and 8-2 |
| AO-12 | Use of the Appraisal Report Options of Standards Rule 2-2 and 8-2 |
| AO-13 | Performing Evaluations of Real Property Collateral to Conform with USPAP |
| AO-14 | Appraisals for Subsidized Housing |
| AO-15 | Using the DEPARTURE RULE in Developing a Limited Appraisal (Retired 7/1/06) |
| AO-16 | Fair Housing Laws and Appraisal Report Content |
| AO-17 | Appraisals of Real Property with Proposed Improvements |
| **AO-18** | **Use of an Automated Valuation Model (AVM)** |
| AO-19 | Unacceptable Assignment Conditions in Real Property Appraisal Assignments |
| **AO-20** | **An Appraisal Review Assignment That Includes The Reviewer's Own Opinion of Value** |
| **AO-21** | **When Does USPAP Apply in Valuation Services?** |
| AO-22 | Scope of Work in Market Value Appraisal Assignments, Real Property |
| AO-23 | Identifying the Relevant Characteristics of the Subject Property of a Real Property Appraisal Assignment |
| AO-24 | Normal Course of Business |
| AO-25 | Clarification of the Client in a Federally Related Transaction |
| **AO-26** | **Readdressing (Transferring) a Report to Another Party** |
| **AO-27** | **Appraising the Same Property for a New Client** |
| **AO-28** | **Scope of Work Decision, Performance, and Disclosure** |
| **AO-29** | **Acceptable Scope of Work** |
| AO-30 | Appraisals for Use by a Federally Regulated Financial Institution |
| **AO-31** | **Assignments Involving More than One Appraiser** |
| AO-32 | Ad Valorem Property Tax Appraisal and Mass Appraisal Assignments |

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101.33 2014-2015 USPAP.

The latest edition of USPAP, effective for calendar years 2014 and 2015, does not contain many changes that impact business valuation analysts. One of the most significant changes is the revised definition of Assignment Results and Scope of Work. In an appraisal assignment, Assignment Results currently include more than just the appraiser's opinion of value, as the appraiser is responsible not only for the opinion of value, but for the other opinions formed as part of an Appraisal or Appraisal Review assignment. The revised definition clarifies this point, as follows:

> An appraiser's opinions or conclusions develop specific to an assignment.
>
> Comment: Assignment Results include an appraiser's—
>
> - opinions or conclusions developed in an appraisal assignment, not limited to value.
> - opinions or conclusions developed in an appraisal review assignment, not limited to an opinion about the quality of another appraiser's work; or
> - not limited to an opinion about the quality of another appraiser's work; or
> - opinions or conclusions developed or performing evaluation service other than an appraisal or appraisal review assignment.

The change to the definition of Scope of Work makes it consistent with the application of the Scope of Work Rule.

101.34 Another important change is the elimination of the “Self Contained Appraisal Report” from all valuation disciplines, allowing only two report options in the 2014-2015 USPAP: an Appraisal Report and a Restricted Appraisal Report. Because the business appraisal reporting standards in Standard 10 never allowed self contained appraisal reports, the only real change for business valuation practitioners is the “Restricted Use Appraisal Report” is now referred to as a “Restricted Appraisal Report.”

101.35 Appraisal Reports continue to be required when the intended users include parties other than the client and Restricted Use Reports continue to be required when the client is the only intended user. The essential difference between an Appraisal Report and a Restricted Appraisal Report is in the content and level of information provided. A Restricted Appraisal Report does not contain the level of information and content that an Appraisal Report should contain. However, the 2014-2015 USPAP requires that a Restricted Appraisal Report should warn the client that the rationale for how the appraiser arrived at the opinions and conclusions used in the report may not be understood properly without referring to additional information maintained in the appraiser's workfile.

101.36 An important change to the 2014-2015 USPAP not having an impact on business valuation is that Standards 4 and 5, related to Real Property Appraisal Consulting, have been retired.

101.37 Future Changes to USPAP.

On December 16, 2014, the ASB issued the fourth (and expected final) exposure draft of proposed changes for the 2016-17 edition of USPAP. One proposed revision that would affect business valuators is the retirement of the five remaining Statements on Appraisal Standards (listed in Exhibit 1-1) and replacing them with Advisory Opinions or Valuation Advisories as published by the APB. One of the consequences of the proposed retirement of the Statements on Appraisal Standards is the expected extension of Advisory Opinions 33, *Discounted Cash Flow Analysis*, and Advisory Opinion 34, *Retrospective and Prospective Value Opinions*, to include business valuations while in previous USPAP editions they applied only to real property and personal property. This could prove to be problematic. If the proposed changes are adopted, business valuation practitioners are advised to become familiar with these two Advisory Opinions.

101.38 There are also some relatively minor proposed revisions to Standard 3 (Appraisal Review, Development and Reporting) to eliminate the requirement to identify and report the effective date of the appraisal review. The exposure draft also proposes to add a certification requirement for an appraisal review report like the one in Standards Rule 10-3 for business appraisal reporting.

101.39 As proposed, the Record Keeping Rule is expected to have a small revision to the definition of *workfile* that would require a workfile to include:

> True copies of *all* written reports, documented on any type of media. (A *true copy* is a replica of the report transmitted to the client. A photocopy or an electronic copy of an entire report transmitted to the client satisfies the requirement of true copy.)

The expected revision to the Record Keeping Rule means that true copies of *final* reports should be maintained in the file for a period of at least five years after preparation or two years after final disposition of any judicial proceeding in which the appraiser provided testimony related to the assignment, which ever period expires last.

101.40 The exposure draft proposes revisions to the definition of (and what is considered) *confidential information* in the Confidentiality section of the Ethics Rule. Also, as questions have arisen regarding the use of the term *assignment*, the ASB has proposed changing the definition of assignment and adding and defining the term *engagement*. As proposed, the definition of *assignment* would be “a valuation service that is provided by an appraiser as a consequence of an engagement” and the definition of *engagement* would be “an agreement between an appraiser and a client in which the appraiser agrees to provide a valuation service.” In other words, an appraiser is engaged to perform an assignment.

101.41 **Standards of the American Society of Appraisers**

The American Society of Appraisers (ASA) was formed in 1936 and, with over 3,200 members worldwide, is a major appraisal testing/certifying organization representing all major disciplines of appraisal specialists, including those who specialize in business valuation. To ensure that professional appraisers adhere to the highest technical and ethical standards in performing valuation projects, ASA has prepared a comprehensive set of *Principles of Appraisal Practice and Code of Ethics* for its members. These standards are appropriate for business valuation specialists as well as appraisers of real estate, machinery and equipment, personal property, and other valuation disciplines. Among other topics, the standards address the following major issues:

a. Objectivity in the performance of appraisal work.

b. The appraiser's obligations to his or her client.

c. The appraiser's obligations to other appraisers and to ASA.

d. General guidance on the application of various appraisal methods and practices.

e. Unethical and unprofessional appraisal practices.

f. Guidance on certain specific explanations, descriptions, and statements that should be included in appraisal reports.

101.42 **Standards of the Business Valuation Committee of the ASA**

Beyond the preceding general standards, the Business Valuation Committee has adopted standards that relate specifically to business valuation engagements. These standards currently include nine Business Valuation Standards, Definitions, two Statements of Business Valuation Standards, one Advisory Opinion, and two Procedural Guideline. These standards, which have been approved by the ASA Board of Governors, are reproduced in Appendix 1A-2.

101.43 **Standards of the National Association of Certified Valuators and Analysts and the Institute of Business Appraisers**

The National Association of Certified Valuators and Analysts (NACVA) was formed in 1991 and is an association focused on training, accrediting, and serving business valuation and litigation support professionals. Current membership is over 7,000. Membership is open to interested professionals. Formed in 1978, the Institute of Business Appraisers (IBA) is an appraisal organization for appraisers who perform valuations of small closely held businesses. In 2011, the two organizations issued unified Professional Standards (unified standards). The unified standards are more principles-based than the prior standards of each organization, but they generally adhere to the reporting requirements of SSVS No. 1. The unified standards are reproduced in Appendix 1A-3. [4]

101.44 **Guidelines of the Internal Revenue Service**

In 1998, the Internal Revenue Service began to examine and comment on its existing valuation practices and policies. Through this process, the IRS established a National Valuation Policy Council (VPC) to set direction and oversee the implementation of valuation policies and utilization of IRS resources.

101.45 In 2002, the IRS business valuation guidelines were issued. In 2006, the guidelines were revised and incorporated into the Internal Revenue Manual (beginning at IRM §4.48.3). The revised IRS business valuation guidelines also include valuation policies and procedures of personal property, intangible property, and real (tangible) property. The business valuation guidelines are a synthesis of USPAP, Revenue Ruling 59-60, and other similar standards. The guidelines relate to the development, resolution, and reporting of business valuation issues and are applicable to IRS and taxpayers' valuators. In addition, the guidelines require certain content included in a signed statement attached to business valuation reports. The revised IRS business valuation guidelines are reprinted in Appendix 1A-4.The authors believe that it is important for the consultant to know and understand these guidelines as the Internal Revenue Service has significant influence over valuation policies and procedures, particularly with estate and gift tax matters.

101.46 The VPC has subsequently been disbanded. In it's place, the IRS established a larger council encompassing all field specialists. However, a few years ago the IRS indicated it will seek external stakeholder participation at some time in the future, but nothing has been publicly discussed since then.

101.47 **International Valuation Standards (IVS)**

The International Valuation Standards (IVS) are promulgated by the International Standards Board (IVSB) of the International Standards Council (IVSC). The IVSC was founded in 1981 as an independent, not for profit, private sector organization that seeks to strengthen the worldwide valuation profession through its international valuation standards, facilitating collaboration and cooperation among its member organizations and other international organizations, and serving as the international voice for the valuation profession.

101.48 The IVSC is a membership organization open to various stakeholders and is currently comprised of 74 member bodies from 54 countries. The IVSC has two technical boards: The International Valuation Standards Board (IVSB), which creates global standards and supporting technical guidance for valuation performance and reporting, and the International Valuation Professional Board (IVPB), which assists in the development of professional practices and supports the worldwide growth of the profession.

101.49 The structure of IVS is somewhat different than its North American counterparts. The IVS consist of the following:

- *Definitions.* This section contains words or phrases that have specific meaning in a context of the standards and are generally consistent with the terminology used from the appraisal organizations in North America.

- *Framework.* This section contains generally accepted valuation concepts and principles upon which the IVS are based and are to be considered and applied when following the standards.

- *General Standards.* This section contains standards having general application for all asset types and valuation purposes subject only to variations or additional requirements specified in the Asset Standards and Valuation Application sections: Scope of Work (IVS 101), Implementation (IVS 202), and Reporting (IVS 103). [The structure of these standards is similar to the structure of the Uniform Standards of Professional Appraisal Practice where scope of work is one of the appraisal rules while each standard discipline (real property, personal property and business valuation) has two standards—one for development and one for reporting.]

- *Asset Standards.* This section provides additional requirements that either modify or supplement the General Standards for specific asset types: Business and Business Interests (IVS 200), Intangible Assets (IVS 210), Plant and Equipment (IVS 220), Real Property Interests (IVS 230), Investment Property Under Construction (IVS 233) and Financial Instruments (IVS 250).

- *Valuation Application.* This section includes any additions or modifications of the requirements in the General Standards and illustrations of how the principles in the General Standards and Asset Standards apply when undertaking valuations applicable to financial reporting (IVS 300) and real property interests for secured lending (IVS 310). [This section also provides guidance on valuation requirements of internationally applicable financial reporting regulations such as the International Financial Reporting Standards (IFRS).]

The IVS may be obtained from the IVSC website at **www.ivsc.org/library/download**.

101.50 **Standards of the Royal Institution of Chartered Surveyors (RICS)**

RICS is a professional organization that regulates property professionals and surveyors in the United Kingdom and throughout the world. RICS has 118,000 members who operate out of 146 countries.

Professional groups cover a multitude of disciplines, such as commercial property, building surveying, machinery and assets, and valuation. RICS is a founding member of the IVSC (which is discussed beginning at paragraph 101.46). RICS operates in the United States through RICS Americas. Headquartered in New York, RICS Americas has been growing rapidly with 3,400 designated members.

101.51 *RICS Valuation—Professional Standards*, known as the "Red Book," contains mandatory rules, best practice guidance, and related commentary for all RICS members undertaking asset valuations. The 2014 Red Book, effective January 6, 2014, has been updated to be fully compliant with 2014 International Valuation Standards (discussed at paragraph 101.48). Although the Red Book is primarily directed at the valuation of tangible real and personal property, RICS indicates that additional guidance regarding business valuation and intangible asset valuation practice will be provided.

101.52 The Red Book consists of the following sections: introduction, glossary, valuation standards, appendices, guidance notes, and the international valuation standards. The six valuation standards are as follows: Compliance and Ethical Requirements (VS 1), Agreement of Terms of Engagement (VS 2), Basis of Value (VS 3), Applications (VS 4), Investigations (VS 5), and Valuation Reports (VS 6). The Red Book can be purchased (or downloaded for free by members) from the RICS website at **www.rics.org**.

101.53 In July 2012, RICS published a Guidance Note: "Application of RICS Valuation—Professional Standards in the United States." The guidance note states that RICS members must take care to insure compliance with U.S. laws and regulations when providing valuation services under U.S. jurisdiction. This guidance note provides assistance to those members on the application of the Red Book to valuations within the U.S. The guidance note is comprised of three sections: Introduction, Terms, and U.S. Jurisdictional Applications. The Terms section discusses the equivalency of prevalent U.S. valuation terms with those in the Red Book. For example, the U.S. term *definition of value* is equal to the Red Book term *basis of value*. As to U.S. jurisdictional applications, an example is that while the Red Book applies to written valuations, when the valuation is to comply with USPAP, oral communications of the valuation results are permitted.

**How These Requirements Affect Exempt Consultants**

101.54 Obviously, the previously mentioned professional standards do not apply to every user of this *Guide*. Attorneys who often serve their clients in an advocacy role, for example, would probably not be concerned with the preceding objectivity issues. Likewise, CPAs employed in industry, under certain circumstances, may not need to comply with those AICPA standards that are designed for public practitioners. The authors believe, however, that the standards of each professional group complement each other and provide a logical foundation for delivering valuation services. The authors recommend that all valuation consultants be aware of both the unique standards of their profession and the standards of related professions and incorporate them into their philosophy of service. The basic valuation standards of each professional organization have been incorporated into the engagement approach presented in this *Guide*.

**Other Valuation Guidance**

101.55 In 2010, The Appraisal Foundation's Board of Trustees announced the formation of the Appraisal Practice Board (APB) to provide voluntary, nonauthoritative guidance concerning recognized methods and techniques in all appraisal disciplines, including business valuation. The purpose the APB and its related advisories is to use The Appraisal Foundation's infrastructure and exposure process to provide nonauthoritative guidance in areas where diversity in practice exists. This is one of the steps that have been taken in response to the challenges stakeholders have expressed regarding the fractious nature of the profession. Since its inception, the APB has been active in business valuation, including the May 2010 issuance of APB Valuation Advisory No. 1, *The Identification of Contributory Assets and Calculation of Economic Rents* (which is discussed further beginning at paragraph 1702.44).

101.56 Currently, the APB has three ongoing projects concerning valuation for financial reporting. In December 2013, the APB issued an initial exposure draft, *Valuation of Customer Related Assets*. The comment period has ended, and the APB expects to issue a final Advisory in 2015. In 2015, the APB also expects to issue an exposure draft, *The Assessment and Measurement of Control Premiums in Valuation for Financial Reporting*, and to issue a discussion draft for its final open project, which addresses the best practices for valuing contingent consideration.

**Impact of Accounting Guidance**

101.57 FASB ASC 820*, Fair Value Measurement*, provides a framework for measuring fair value in GAAP and disclosures about fair value measurement. The guidance provides the definition and measurement process of fair value used in existing accounting literature. See the paragraphs beginning at 201.8 for further discussion of FASB ASC 820.

101.58 **SEC's Involvement in the Valuation Profession**

The Securities and Exchange Commission (SEC) is also taking greater interest in the valuation profession. At the 2011 AICPA Conference on Current SEC and PCAOB Developments, Paul A Beswick, currently the SEC Chief Accountant, expressed his views on the current state of the United States valuation profession in the context of financial reporting. Mr. Beswick indicated that valuation professionals serve two purposes within the financial reporting process. They can either be management's specialists, assisting the company in the estimation of value, or they can be the auditor's specialist in the evaluation of management's models, assumptions, and/or value conclusions.

101.59 Mr. Beswick also noted that valuation professionals can choose among five business valuations credentials available from four different organizations, each with its own criteria for attainment, but none of which is actually required to be among the ranks of the profession. Mr. Beswick indicated that the fragmented nature of the valuation profession has led to an erosion of trust in the process, and he called for a single set of qualifications with respect to education level and work experience, a continuing education curriculum, standards of practice and ethics, and a code of conduct.

101.60 At the 2013 AICPA Conference on Current SEC and PCAOB Developments, Mr. Beswick again addressed the need for valuation profession to make strides in improving themselves as a profession. His tone was cautionary but slightly more upbeat, indicating:

> In my discussion among valuation professionals, I feel that there is a general commitment by stakeholders to make the necessary improvements in the valuation profession. But it is too early to declare victory. While there has been a lot of healthy dialogues, the next step is still needed to make firm commitments to assess the valuation profession. I hope that collectively we can improve the structure of the valuation profession so that investors have the confidence in the information they need to make sound investing decisions.

101.61 **SEC Participation in TAF Roundtables**

In April 2012, The Appraisal Foundation (TAF) hosted a roundtable discussion, *The Business Valuation Profession as it Relates to Financial Reporting (VFR): Where are we Headed*. In addition to Mr. Beswick representing the SEC, participants included academics, practitioners, and individuals from the FASB, PCAOB, and CFA Institute. The discussion centered around three topics: minimum qualifications for a valuation specialist to prepare a fair value measurement for financial reporting, valuation standards and/or best practices, and oversight.

101.62 Although the TAF roundtable produced no definitive solutions, it did identify certain issues that need to be addressed to enhance public trust in the profession. The majority of the regulator's attention was on best practices rather than consolidating the standards. However, the most challenging area was in oversight, where, unlike real property, no central enforcement organization exists, leaving enforcement to the individual member organizations.

101.63 On June 30, 2013, the TAF hosted a second roundtable, *Fair Value and Financial Reporting: Auditors and Registrants* (Roundtable II). This was a continuation of the April 2012 roundtable with an emphasis on auditors and registrants. The same basic format was used, but the goal was to get a user's perspective on these issues. Roundtable II was well attended by auditors and valuation practitioners from the major accounting firms, as well as regulators. As the title implies, the roundtable focused on the auditor's view of the issues concerning the application fair value for financial reporting. Similar to the initial roundtable, Roundtable II produced no definitive solutions, but it was designed to continue the dialogue initiated from the initial roundtable, dealing with problem identification, qualifications, standards, and enforcement.

101.64 In January 2014, the Board of Trustees of the Appraisal Foundation established the Business Valuation Resource Panel (BVRP) to raise the profile of the business valuation discipline and help the Appraisal Foundation successfully reach out to additional constituents. More specifically, the BVRP is to provide a permanent forum to consider a number of professionally relevant issues, aimed at maintaining and enhancing the public trust in the business valuation discipline, including but not limited to the following:

- Consideration of a universal accreditation/certification framework.

• Consideration of the creation of a “national registry” of valuation specialists/appraisers in this discipline.

• Development of a comprehensive framework for the consideration of discipline-specific standards and/or recognized methods and techniques.

• Development of a unified framework for the consideration of discipline-specific qualifications, potentially for future submissions to the Appraisal Foundation's Appraiser Qualifications Board (AQB).

• Consideration of methods of oversight across the various disciplines, recognizing that the nature of the entities or assets valued, and the purposes of valuation may not fall under the auspices of the Financial Institution Reform, Recovery and Enforcement Act (FIRREA) or state appraisal regulation.

101.65 Another directive of the BVRP is to sponsor future SEC roundtables on business valuation and financial reporting. There are expectations to have the next roundtable in the latter part of 2015.

**Impact of Federal Legislation on Business Valuers**

101.66 **Licensing and Certification of Real Estate Appraisers**

Title XI of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) requires each state to establish a real estate appraiser licensing or certification system from which only its members would be allowed to perform real estate appraisals in connection with a federally-related transaction. At first glance, this Act would not appear to be relevant to business valuers; however, the real estate appraisal laws enacted by most states are so broad that a valuation of a business with substantial real estate assets by a business appraiser could cause the valuation report and all those who participated in the valuation to fall within the regulatory scrutiny of the state appraiser licensing authority. Accordingly, business valuers should review the laws of their states dealing with licensing or certifying real estate appraisers to ensure that an engagement involving a business with substantial real estate assets complies with the state's appraiser licensing laws. In a few states, the real estate appraisal licensing law is written in a such a broad way that it could be interpreted as possibly including professional appraisers who are business valuers or even personal property appraisers. The ASA has taken an active role by urging any state that has adopted licensing rules that appear to have gone beyond the original intent of FIRREA to amend those rules to exclude business or personal property valuations.

101.67 The issue of whether, and under what circumstances, a business valuation consultant valuing a going concern with substantial real property assets should hire a real estate appraiser to value those assets recently took on added importance when the Small Business Administration (SBA) decided to amend its valuation policies to permit properly qualified real estate appraisers to value going concerns with special use real properties in connection with SBA guaranteed loans to those businesses.

101.68 Unless required by an overly broad state law, the need to employ an appropriately licensed real estate appraiser will depend on the nature of the entity, the relevancy of its real estate assets, and the interest to be valued. The ASA has prepared a release titled *Business Appraiser or Real Property Appraiser—Determining Which to Use*, to help valuation consultants identify situations when a real estate appraiser should be involved in a valuation engagement. "The Business Appraisal or Real Property Appraisal Checklist" at Exhibit 1-2 is from the ASA's release.

**Exhibit 1-2**

**Business Appraisal or Real Property Appraisal Checklist**

The following checklist helps determine which discipline—business appraisal or real property appraisal—is the pertinent appraisal discipline when valuing an entity. In some cases, as indicated by the checklist, both disciplines may be required.

| | **A BUSINESS APPRAISAL** | | **A REAL PROPERTY APPRAISAL** |
|---|---|---|---|
| | Is the entity to be appraised: | | |
| [ ] | A commercial, industrial or service organization pursuing an economic activity other than the sole operation of real estate? | [ ] | A residential or commercial property (such as a single family residence, apartment house or office building)? |
| [ ] | An equity interest (such as a security in a corporation or partnership interest)? | [ ] | An interest in real estate (such as tenant in common or joint tenancy)? |
| [ ] | A fractional or minority interest (i.e., less than 100 percent of the entity)? | [ ] | A whole or partial interest in real estate? |
| [ ] | Difficult to split up (perhaps because the owners do not have a direct claim on the assets)? | [ ] | Owners have a direct claim on their real estate interest? |
| | Does the entity to be appraised: | | |
| [ ] | Derive its revenues from providing goods or services? | [ ] | Derive its revenues from the use or leasing of real estate? |
| [ ] | Primarily use assets such as machinery, equipment, employee skill and talent in | [ ] | Use real estate as its primary asset? |

| | | | |
|---|---|---|---|
| | providing goods or services, and depend on assets other than or in addition to real estate to generate earnings? | | |
| [ ] | Conduct an economic activity which is more important than the location of the real estate where the economic activity is being conducted? | [ ] | Conduct an activity wherein the location of the real estate is a primary valuation factor? |
| [ ] | Likely have a value that fluctuates with conditions in its industry (as opposed to fluctuations in the real estate market)? | [ ] | Have a value which fluctuates primarily with the real estate market? |

<u>Does the entity have:</u>

| | | | |
|---|---|---|---|
| [ ] | Intangible assets such as patents, trademarks, copyrights, franchises, licenses, customer lists, employment contracts, non-compete covenants and goodwill which the entity uses to generate earnings? | [ ] | Assets that are primarily tangible real estate. Insignificant or no intangible assets? |
| [ ] | Substantial assets that can be moved? | [ ] | Real estate and real estate related assets that cannot be moved? |
| [ ] | A variety of tangible and intangible assets which interact to produce economic activity? | [ ] | Primarily tangible real estate assets that produce the economic activity in the form of lease revenue or real estate use? |
| [ ] | Significant operating expenses such as management, labor, marketing, advertising, research and transportation? | [ ] | Operating expenses that are limited to real estate oriented expenses such as property management and maintenance? |

[SOURCE: *Business Appraiser or Real Property Appraiser—Determining Which to Use*, Reprinted with permission, American Society of Appraisers, 555 Herndon Parkway, Suite 125, Herndon, VA 20170.]

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101.69 **Customer Privacy Policies**

The Financial Services Modernization Act of 1999, commonly referred to as the Gramm-Leach-Bliley Act (the GLB Act), was enacted to, among other items, protect the privacy and security of nonpublic personal financial information that consumers provide to financial institutions. In the same manner that the IRS issues regulations interpreting the tax statutes, the Federal Trade Commission (FTC) is responsible for promulgating the rules on the privacy of consumer financial information under the GLB Act. The FTC's regulations significantly expand the definition of financial institutions and include within this definition businesses such as tax preparers and financial planners not traditionally thought of as financial institutions.[5]

101.70 The Financial Services Regulatory Relief Act of 2006 includes an exemption for CPAs from the privacy disclosure provisions of the GLB Act, since the AICPA Code of Professional Conduct already protects the confidentiality of client information. As a result of this exemption, CPAs are no longer required to send out annual privacy disclosure statements to each of their clients detailing the financial information they retain and what disclosures of that information they are allowed to make. The legislation, however, does not exempt CPAs from the requirements that they secure client information and have written procedures to protect client financial information. (Some state laws may still require CPAs to maintain a privacy policy; therefore, CPAs should follow applicable state laws.) The following discussion focuses on the impact of the GLB Act to non-CPA business valuation professionals.

101.71 Real estate and personal property appraisal firms are considered “nontraditional financial institutions” based on an earlier and unrelated regulatory determination by the Federal Reserve Board, which stated “performing appraisals of real estate and tangible and intangible personal property, including securities . . . are usual activities related to extending credit.” [6] The FTC has also determined that “personal property or real estate appraisers” are subject to its GLB Act's Safeguards Rule, which requires financial institutions under FTC jurisdiction to have measures in place to keep customer information secure. Although the FTC has not been asked, nor has it ruled, whether business valuation services are considered in this definition, it would appear that they may be included because valuation firms may obtain nonpublic financial information about consumers when performing valuation services for a traditional financial institution. For example, a bank may engage a valuation consultant to value a business in connection with granting or extending a loan.

101.72 Another important term is *nonpublic personal information* which is defined as “any personally identifiable financial information that a financial institution collects about an individual in connection with providing a financial product or service, unless that information is otherwise publicly available.” Thus, a valuation consultant that deals only with business clients presumably would not be affected by the new disclosure rules unless some of those business clients were sole proprietors or single-member LLCs owned by an individual. Valuation services provided to individual clients in connection with business valuation engagements could be subject to the disclosure rules unless they are specifically exempted, as discussed in the following paragraph.

101.73 Exceptions and Exemptions.

The FTC's rules provide various exemptions from its rules related to the GLB Act, including the following:

- Appraisal services provided for business purposes. Thus, if the services are *not* performed for a client's personal, family, or household purposes, then they are not covered by the FTC rules. However, business valuations services performed for personal estate planning or divorce purposes may be subject to the rules unless they are exempted by other factors.

- Appraisal services where a “customer relationship” does not exist between the appraiser and a consumer. A customer relationship is defined as “a continuing relationship between a consumer and a financial institution," and according to the rule, "a consumer does not . . . have a continuing relationship with you if. . . . (D) The consumer obtains one-time personal or real property appraisal services from you. . . . " Thus, any one-time valuation engagement would appear to be exempt from the Act. In addition, the "Supplementary Information" section of the FTC rule states that, "Real estate appraisers who perform services for a financial institution, but do not provide financial products or services to individuals, will not be required to make the disclosures mandated by the rule because they do not have 'consumers' or 'customers' as defined in the rule."

• The disclosure of nonpublic personal information to a nonaffiliated third party when that disclosure is necessary to effect or administer a transaction requested by the consumer. For example, an appraisal firm performing services for a nonaffiliated financial institution may, without incurring any privacy responsibilities, receive nonpublic personal information from that institution when disclosure is necessary to effect or administer a transaction that a consumer requests. However, the FTC's rule makes it clear that the appraisal firm would still be required to observe the rule's limitations on reuse and redisclosure of that information.

101.74 Requirements.

Those entities that are considered "traditional or nontraditional financial institutions" under the FTC's rules have three basic disclosure duties to their customers (as well as, of course, a duty to adhere to the substantive limitations on disclosure):

• To provide both an initial notice about their privacy policies and a subsequent annual privacy notice at least once in each 12-consecutive-month period;

• To describe the conditions under which they may disclose nonpublic personal information about consumers to nonaffiliated third parties;[7] and,

• To provide a method for their customers to "opt-out" of such otherwise permissible disclosures, or provide a statement that their firm does not disclose nonpublic personal information about clients or former clients except as authorized by law.

In addition, those entities covered by the GLB Act must also develop and implement written policies and procedures for safeguarding customer records and information.

101.75 If the engagement to be performed by a valuation consultant is covered by the GLB Act, the authors recommend sending a privacy notice to the new client along with the initial engagement letter. The FTC rule requires that these initial and annual notices to clients be clear and conspicuous and accurately reflect the firm's privacy policy and practices. In addition, the notices normally must be in writing and they must be mailed to a client's last known address (unless hand-delivered).

101.76 The GLB Act specifically permits states to enact privacy protections for nonpublic financial information that may give individuals greater protections than are currently available under the federal law. Thus, valuation consultants should be alert for any state laws that may be enacted related to privacy issues.

101.77 **Regulations Governing Practice before the IRS**

Treasury Department Circular No. 230 (Circular 230) governs practice before the IRS by CPAs, attorneys, enrolled agents, and others authorized to represent taxpayers before the Service. Although not regarded as “practitioners,” appraisers are subject to many provisions of Circular 230, including sanctions for violations of its provisions. As a response to the explosive growth of what it considers questionable tax avoidance schemes, the IRS has made a number of important modifications to Circular 230 over recent years to strengthen, perfect, simplify and extend its reach. For example, its reach was greatly extended when, on June 3, 2011, the U.S. Department of Treasury (Treasury) and IRS published final regulations which (a) established registered tax return preparers (now totaling about 500,000) as a new category of regulated tax practitioner recognized and governed by the Circular's ethics, due diligence, and education and testing requirements,[8] and (b) explicitly brought appraisers within most of its provisions.[9]

101.78 Prior to June 12, 2014, many practitioners relied on the provision in section 10.35 of Circular 230 that gave the practitioner the option, in lieu of issuing a reliance opinion, to include a disclaimer in the written advice that clearly stated that the written advice is not intended by the practitioner to be relied on by the taxpayer to avoid penalties resulting from taxpayer's federal tax positions. The following is an illustrative example of such language:

> <u>IRS Circular 230 Disclosure:</u> To ensure compliance with the requirements imposed by the IRS, we advise you that if this communication or any related attachment contain U.S. federal tax advice, it is not intended or written to be used, and cannot be used, for the purpose of (a) avoiding federal tax penalties under the Internal Revenue Code or (b) promoting, marketing or recommending to another party any transaction or matter addressed herein.

101.79 However, effective June 12, 2014, the IRS revised Circular 230, including revisions to section 10.35 that eliminate the reliance opinion requirements and the written advice disclaimer provision. In its place, new provision 10.37 establishes reasonableness standards for a tax practitioner's written advice, including advice based on third party information (such as an appraisal report). The Treasury and IRS eliminated the boiler-plate disclaimer provision after concluding that it and the other section 10.35 requirements were confusing, unnecessarily complex and ineffective. The IRS is enforcing this provision change by sending notices to practitioners/entities if it becomes aware of continued use of the written advice disclaimer.

101.80 Concerning situations in which the practitioner has relied on the advice of others, the revised rule states the “Treasury and IRS have determined that the provisions of Section 10.37(b) [reliance on the advice of others] should apply to a practitioner who relies on advice from any other person, including appraisers and other individuals not defined as practitioners under Circular 230.” The final rule establishes a three-part test for whether a practitioner's reliance on the advice of an appraiser or other professional is reasonable and made in good faith.

101.81 With respect to the advice of appraisers, the key test is whether “The practitioner knows or reasonably should have known that the person [relied on] is not competent or lacks the necessary qualifications to provide the advice.” However, the final rule does not provide specific guidance on what facts or circumstances would cause a practitioner to reasonably conclude that the appraiser or other person relied on is not competent or lacks necessary qualifications. The final rule also established that an appraiser disqualified from practice before the IRS must wait five years before filing an application for reinstatement.

101.82 The Pension Protection Act of 2006 expanded the categories of sanctions that can be imposed on appraisers by authorizing the IRS to disbar or suspend appraisers from practice before the IRS for substantive violations of Circular 230 standards or other Internal Revenue Code requirements applicable to appraisers, such as valuation misstatements. The Treasury's implementation of this additional sanction authority, which became effective on August 2, 2011, helped clarify Circular 230's precise impact on appraisers who provide tax-related valuation services. Although Circular 230 has long referenced appraisers, prior to this change, a uncertainty existed with respect to exactly how the Circular's provisions applied to appraisers and how the IRS could enforce them. For example, Circular 230 explicitly references appraisers in many of its most important provisions, including the following:

a. *Subpart C—Sanction for Violation of the Regulations.* Section 10.50(b) provides that the “Treasury Secretary, or delegate, may disqualify any appraiser for a violation of these rules as applicable to appraisers.” (The phrase *these rules* generally refers to the rules applicable to practitioners in Part 10.0 of the Circular.) Upon disqualification:

(1) “ . . . the appraiser is barred from presenting evidence or testimony in any administrative proceeding before the Department of Treasury or the Internal Revenue Service, unless and until authorized to do so by the Internal Revenue Service pursuant to Section 10.81” (“Petition for Reinstatement”).

(2) Any appraisal made by a disqualified appraiser after the effective date of disqualification will not have any probative effect in any administrative proceeding before the Department of the Treasury or the Internal Revenue Service . . . .” In August 2011, the Office of Professional Responsibility (OPR) issued important written guidance clarifying that these provisions appear to prohibit a disqualified appraiser from

preparing an appraisal for tax return purposes and not just from providing testimony or support in a tax-related proceeding. The guidance ("Guidance on Restrictions During Suspension or Disbarment from Practice Before the Internal Revenue Service") states that "A suspended or disbarred individual may not (1) prepare or file documents (including tax returns) or other correspondence with the IRS." The term *document* includes an appraisal report. The guidance also states, "OPR will consider an individual's practice, or attempt to practice, while suspended or disbarred as a factor militating against the individual's reinstatement to practice."

b. *Subpart D—Rules Applicable to Disciplinary Proceedings.* Paragraph (b) of Section 10.60, "Institution of proceeding," establishes a standard of conduct for appraisers, the violation of which could give rise to sanctions proceeding against an appraiser. It states that "whenever a penalty has been assessed against an appraiser under the Internal Revenue Code and an appropriate officer or employee in an office established to enforce this part determines that the appraiser acted willfully, recklessly, or through gross incompetence with respect to the proscribed conduct, the appraiser may be reprimanded or . . . subject to a proceeding for disqualification. A proceeding for disqualification of an appraiser is instituted by the filing of a complaint . . . ." Paragraph (b) of Section 10.76, "Decision of Administrative Law Judge," states that "If the sanction is censure or a suspension of less than six months' duration, the Administrative Law Judge . . . will consider an allegation of fact to be proven if it is established . . . by a preponderance of the evidence in the record. If the sanction is a monetary penalty, disbarment or a suspension of six months or longer duration, an allegation of fact . . . must be proven by clear and convincing evidence in the record."

101.83 As stated in item a of the previous paragraph, the Treasury may "disqualify any appraiser for a violation of these rules as applicable to appraisers." The phrase *these rules* generally refers to the rules applicable to practitioners in Part 10.0 of the Circular. Thus, it can be argued that although appraisers have never been determined to be "practitioners," they are nevertheless subject to the Circular 230 standards, including those stated in Section 10.50(a) which authorizes the Treasury or IRS to censure, suspend or disbar any practitioner from practice before the IRS if the practitioner "is shown to be incompetent or disreputable, fails to comply with any regulation in this part or with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client. Censure is a public reprimand."

101.84 It appears there are two preconditions for IRS sanctions against appraisers under Circular 230. First, it must be determined that the appraiser acted "willfully, recklessly, or through gross incompetence with respect to the proscribed conduct;" and second, the misconduct must be proven to an administrative law judge based on the appropriate burden of proof relative to the degree of sanction. [Prior to the Pension Protection Act and implementation of its appraisal provisions (including required changes to Circular 230), authority to take enforcement actions against appraisers was essentially limited to finding that the appraiser violated IRC Sec. 6701 because they “knowingly aided and abetted a taxpayer's understatement of tax liability,” which resulted in a small civil fraud penalty.]

101.85 Although the latest changes to Circular 230 provide useful clarity as to the nature and extent of its applicability to appraisers, they do not address situations in which an appraiser, whose only interaction with the IRS involves the preparation of tax-related appraisals, also qualifies as a practitioner under Circular 230 (e.g., as an attorney or CPA). For example if an appraiser is also a CPA but only performs valuation services, would the appraiser only be subject to Circular 230's appraiser-related standards and sanctions regime or, as a CPA, would the appraiser also be subject to the standards and sanctions applied to a practitioner? What about situations where an individual is both a CPA and a qualified appraiser whose regular book of business involves tax preparation services but occasionally performs tax-related appraisals in separate engagements? Currently, there is no clear guidance or precedent on how the IRS would respond. Individuals who are professional appraisers but who also meet the Circular 230 definition of a tax practitioner and work in the tax area, would be well advised to seek further guidance on how their role as valuation consultant is impacted by Circular 230.

101.86 A related issue of potential importance involves the question of whether (and under what specific circumstances) an appraiser performing tax-related valuation services can also be regarded as a signing or non-signing tax return preparer; and, as a result, be subject to the IRS penalty regime for tax return preparers under IRC Secs. 6694 and 6695. See the paragraphs beginning at 101.105 for a discussion of the final regulations issued by the Treasury and IRS regarding this question.

101.87 **Taxpayer Penalties**

IRS penalties against taxpayers resulting from appraisal inadequacies that result in an underpayment of taxes add importance to the obligation of business valuation professionals to produce a reliable and defensible conclusion of value. Thus, one of the tax-related appraisal practice changes introduced by the Pension Protection Act of 2006 (PPA) involved increasing the accuracy-related penalties on taxpayers for underpayment of taxes, including a penalty equal to 20% of the underpayment attributable to a “substantial” valuation misstatement or a penalty equal to 40% of the underpayment attributable to a “gross” valuation misstatement. Another appraisal practice change introduced by the PPA was lowering the thresholds for triggering “substantial” and “gross” valuation misstatements. Specifically, the PPA reduced the triggering threshold for substantial valuation misstatements to differences of at least 150% (previously 200%) between the value of property claimed on a return and the amount determined to be the correct value. For gross valuation misstatements, the triggering threshold was reduced to differences of at least 200% (previously 400%) of the amount determined to be the correct value. (The triggering thresholds for valuation misstatements related to estate and gift tax returns are discussed beginning at paragraph 1001.46.)

101.88 **Appraiser Penalties**

The PPA introduced extensive changes for tax-related appraisal practices as part of a general and ongoing attempt by Congress and the IRS to ensure appraisal reliability, improve the qualification requirements for those who provide tax-related valuations, and increase a valuator's accountability for their valuation conclusions. Additionally, the PPA mandated greater valuation skills from those performing tax-related appraisals and adherence to uniform standards for the contents of appraisal reports. Specifically, the PPA's appraisal reforms include the following:

a. A revised definition of the term *qualified appraiser*, requiring enhanced valuation qualifications that individuals must possess to be eligible to perform tax-related appraisals for certain tax purposes.

b. A requirement that, in order for the appraisal to be considered a *qualified appraisal*, it must meet uniform content requirements pursuant to Treasury standards.

c. Increased civil monetary penalties on valuators whose value conclusions are found to constitute a substantial or gross valuation misstatement in addition to the IRC Sec. 6701(a) and Circular 230 penalties. Other Tax Acts clarified that a substantial estate or gift tax valuation understatement is also grounds for the new civil monetary penalty. For further discussion of the new IRC Sec. 6695A penalty and other tax-related penalties against appraisers, see the paragraphs beginning at 1001.50.

d. The authority to disqualify appraisers from practice before the IRS for engaging in prohibited practices, including a pattern of valuation misstatements.

101.89 The valuation analyst acknowledges an understanding of the PPA and other appraisal provisions by completing the Declaration of Appraiser, which is part of Form 8283 and required for noncash charitable contributions over certain dollar thresholds. A central portion of the Declaration contains the following representations:

> Also, I declare that I perform appraisals on a regular basis; and that because of my qualifications as described in the appraisal, I am qualified to make appraisals of the type of property being valued. I certify that the appraisal fees were not based on a percentage of the appraised property value. Furthermore, I understand that a false or fraudulent overstatement of the property value as described in the qualified appraisal or this Form 8283 may subject me to the penalty under section 6701(a) (aiding and abetting the understatement of tax liability). In addition I understand that I may be subject to the penalty under section 6695A if I know, or reasonably should know, that my appraisal is to be used in connection with a return or claim for refund and a substantial or gross

valuation misstatement results from my appraisal. I affirm that I have not been barred from presenting evidence or testimony by the Office of Professional Responsibility.

101.90 Initially, there was some speculation that PPA appraisal provisions applied only to valuations performed in connection with non-cash charitable contributions. However, in November 2007, the Office of Chief Counsel of the Internal Revenue Service published a memorandum (AM 2007-0017) stating that the valuation misstatement and penalty provisions of new Code section 6695A (see paragraph 101.88, item c.) apply to any appraiser for valuations prepared after May 25, 2007 that are used in connection with an estate or gift tax return or claimed refund or credit. Thus, these PPA appraisal provisions effectively apply to all tax-related valuations and to those who prepare them.

101.91 Civil Penalties Under IRC Sec. 6695A.

In August 2009, the Small Business Self Employed division of the IRS issued SBSE Interim Memorandum 04-0809-015, *Penalty for Valuation Misstatements Attributable to Incorrect Appraisals*, which provided interim guidance to all IRS examiners, Revenue Agents, and Tax Compliance Officers for assessing IRC Sec. 6695A civil penalties for valuation misstatements. The memo covered examination procedures, including who can assert the penalty, the procedure used to assert such penalty, and the role in this process of Field Specialists with valuation training. The guidance in the memo was made permanent when added to Part 20 of the IRS's Internal Revenue Manual (IRM). Part 20.1.12 of the IRM (Penalties Applicable to Incorrect Appraisals), describes in great detail how the IRS asserts a Tax Code section 6695A valuation misstatement case against an appraiser, including detailed due process protections that are available to appraisers whose valuations are reviewed by IRS examiners. Among those protections is Letter 4477 which the IRS is required to send to those appraisers in situations where the Service wants to schedule an audit appointment with them about a possible valuation misstatement. Note that Letter 4477 may only be used after the IRS has made two unsuccessful attempts to reach the appraiser by telephone.

101.92 Defining *Qualified Appraiser and Qualified Appraisal*.

To provide some clarity to the scope of the PPA's appraisal reform provisions, the Treasury Department and IRS issued interim guidance (Notice 2006-96, “Guidance Regarding Appraisal Requirements for Noncash Charitable Contributions”). According to the interim guidance, a qualified appraiser (a) has earned an appraisal designation from a recognized appraisal organization or has otherwise met minimum education and experience requirements set forth in regulations, (b) regularly performs appraisals for compensation, and (c) meets such other requirements as may be prescribed in regulations or other guidance. The interim guidance also states that an individual will *not* be treated as a qualified appraiser unless that individual demonstrates verifiable education and experience in valuing the type of property subject to the appraisal and has not been prohibited from practicing before the IRS for violations of Circular 230 requirements during the 3-year period ending on the date of the appraisal.

101.93 Also, according to the interim guidance, a *qualified appraisal* is conducted by a qualified appraiser in accordance with generally accepted appraisal standards, such as the Uniform

Standards of Professional Appraisal Practice (USPAP) and meets any other regulations or guidance prescribed by the Treasury Secretary. While much attention has focused on the use of USPAP as an example of generally accepted appraisal standards, it is clear from the guidelines that other standards which are consistent with the substance and principles of USPAP will be acceptable as well.

101.94 The IRS and Treasury published proposed regulations implementing a number of the PPA's appraisal provisions. As drafted, proposed Reg. 1.170A-17(a)(2) states that “generally accepted appraisal standards means the substance and principles of the Uniform Standards of Professional Appraisal Practice, as developed by the Appraisal Standards Board of the Appraisal Foundation.” The IRS has held public hearings on various aspects of the proposed regulations, including one that covered the IRS's proposed rules concerning (a) who is qualified to perform appraisals in connection with valuing noncash charitable contributions and (b) how such appraisals should be performed. However, as of December 2012, the IRS has not issued final regulations implementing the PPA's appraisal provisions, so Notice 2006-96 and AM 2007-0017 continue to apply.

101.95 <u>Potential Practice Issues Under the Proposed Regulations and Interim Guidance for IRC Sec 6695A</u>.

Through the public hearings and other means, there has been criticism of certain aspects of the proposed regulations and the related IRC Section 6695A penalties. Some have indicated that the percentage approach used in the regulations to determine valuation misstatements demands false precision for certain categories of valuations. Critics point out that different asset classes are subject to different valuation variances. For example, the valuation of financial derivatives could be subject to greater valuation variances than the valuation of commercial or residential real estate. Serious criticisms also have been raised regarding the precise meaning of the safe harbor language of 6695A, which creates an exception to the valuation misstatement penalty if the appraiser “establishes to the satisfaction of the Secretary that the value established in the appraisal was more likely than not the proper value.” The meaning of this safe harbor phrase and other IRC Sec. 6695A provisions has never been addressed by the Service even though the adoption of regulations implementing IRC Sec. 6695A has been promised in every IRS Priority Guidance Plan over many years.

101.96 Another criticism is the timeframe within which such penalties can be assessed. For example, in 2006, the Fifth Circuit Court of Appeals [10] overturned the Tax Court's 2003 opinion. The gifts that were the subject of this decision were made in 1996. In the lower court case, the court rejected the valuation expert's use of restricted stock studies as the basis for the discount for lack of marketability. If a similar fact pattern occurred, according to the proposed regulations, would the taxpayer's appraiser be subject to the appraiser penalties under IRC Section 6695A years before final resolution of the valuation conclusion? If, after final resolution in favor of the taxpayer (and the appraiser), would the appraiser receive a refund (with interest) of previously paid penalties?

101.97 Although critics use *McCord* as an example of the difficulties in practically applying the assessment of penalties under IRC Section 6695A and the proposed regulations, the IRS is likely to propose additional regulations to implement other provisions of the PPA. It is expected that future regulations will address the imposition of monetary penalties (and other sanctions) against appraisers, standard of care issues, and other due process issues.

101.98 Also, there were strong objections to the penalty assessment procedures described in SBSE Memorandum 04-0809-015 (discussed at paragraph 101.87) because of a belief that the procedures lacked adequate due process safeguards for appraisers and because they failed to define *safe harbor* terms, without which a valuation misstatement finding cannot realistically be asserted by the IRS. Due to these objections, the major U.S. business valuation groups responded to the IRS as described in the following paragraph.

101.99 Major U.S. business valuation groups (primarily AICPA, ASA, NACVA, and IBA) responded to an internal IRS enforcement document establishing a process for imposing civil money penalties on appraisers for alleged valuation misstatements. They argued the proposed penalty assessment process was seriously flawed and grossly unfair to appraisers. The primary complaints were that the IRS process failed to provide the valuation consultant: (a) notice that their appraisal was being examined and (2) an opportunity to justify their conclusion of value prior to a penalty being proposed. As a result, the IRS made substantial changes to its process for assessing valuation misstatement penalties at Part 20.1.12 of the IRM, providing valuation consultants with a certain degree of due process.

101.100 See paragraph 101.103 for discussion of limited final guidance concerning appraiser penalties under IRC Sec. 6695A and the paragraphs beginning at 1001.50 for further discussion of penalties against appraisers under IRC Sec. 6695A.

101.101 <u>Authors' Viewpoints.</u>.

The relevance of the PPA's valuation provisions to practitioners is clear. The PPA mandates that valuation consultants be able to demonstrate necessary qualifications (e.g., education, training, and experience) to value the tangible and/or intangible property type at issue in a tax return and that they adhere to generally accepted uniform appraisal standards in the preparation of a valuation.

101.102 While the relevancy of the PPA provisions to valuation consultants is clear, their precise impact on how valuation consultants practice before the IRS is still a work in progress. Although for the last several years the IRS' Guidance Priority Business Plans have “promised” final implementation of the PPA's appraisal provisions relating to the civil money penalty provisions of IRC Sec. 6695A (including the meaning of the safe harbor “more likely than not the proper value” phrase contained in the valuation misstatement section of the law), final rules have not been proposed. As a consequence, after five years, the IRS has not addressed some PPA valuation provisions while the issues it has addressed remain as interim guidelines. Accordingly, those who provide tax-related valuation services currently operate within the framework of more stringent statutory requirements without final guidance on how the IRS intends to implement those provisions.

101.103 **Tax Preparer Penalties**

The Small Business and Work Opportunity Act of 2007 (2007 Act) amends IRC Sec. 6694, making the penalties for valuation misstatements applicable to a broader range of tax returns and claims for refund. Previously, such penalties were restricted to income tax return preparers. However, the definition now includes preparers of other types of tax returns, including estate, gift, employment, and excise tax. As discussed in the paragraphs beginning at 1001.52, the 2007 Act also increased the IRC Section 6694 penalties for tax preparer understatements due to unreasonable positions and due to willful or reckless conduct.

101.104 Final regulations implementing amendments to the tax return preparer and appraiser penalties under IRC Secs. 6694 and 6695 are in Rev. Proc. 2009-11. The final regulations change the standards of conduct that tax return preparers must meet to avoid the imposition of penalties in the event that a prepared tax return results in an understatement of tax. The final regulations also expand the scope of penalty provisions of IRC Section 6695 beyond income tax returns.

101.105 Perhaps the most important issue is that, for the first time, the IRS and Treasury Department have explicitly addressed the issue of whether valuation professionals are within the definition of tax return preparers and subject to penalties under IRC Sec. 6694. The IRS has determined that under certain narrow circumstances, an appraiser can be considered a non-signing return preparer and subject to Code section 6694 penalties “if the appraisal is a substantial portion of the return or claim for refund and the applicable standards of care under section 6694 are not met.” In response to the assertion of a professional appraisal organization that imposing 6694 penalties on appraisers would be gratuitous because appraisers are already subject to civil money penalties under IRC Sec. 6695A, the Treasury and IRS determined that “it will not stack the penalties under sections 6694 and 6695A with respect to the same conduct.” The following is a reprint of the section of the final regulations in Treasury Decision (TD) 9436 that specifically deals with appraisers.

> Under Treasury Regulations in place since 1977 and the proposed regulations, an appraiser might be subject to penalties under section 6694 as a nonsigning tax return preparer if the appraisal is a substantial portion of the return or claim for refund and the applicable standards of care under section 6694 are not met. Several commentators have stated that appraisers should not be subject to penalties under section 6694 because they are subject to new, higher standards of conduct under section 6695A as set out in the Pension Protection Act of 2006, Public Law No. 109-280. The commentators have also urged that the assessment of penalties under section 6694 against appraisers would result in the imposition of a gratuitous and unnecessary layer of requirements and sanctions without any additional public policy benefit.
>
> After consideration of the comment, the Treasury Department and the IRS continue to include appraisers in the definition of both signing and non-signing preparers, thereby providing the IRS with discretion to impose the section 6694 and 6695A penalties in the alternative against an appraiser depending on the facts and circumstances of the appraiser's conduct. The IRS, however, will not stack the penalties under sections 6694 and 6695A with respect to the same conduct. A separate regulation will provide guidance under section 6695A.

With the clarification that valuation analysts are, under narrow circumstances, specifically included in the definition of both signing and non-signing preparers and subject to the penalties under IRC Sections 6694 and 6695, practitioners should know these regulations in detail.

101.106 While these new standards of care have been applied in other contexts, they have never been addressed in the context of valuations or valuation practitioners. For example, one standard of care is "reasonable basis" for disclosed positions. The term might mean one thing for a preparer who is interpreting tax law but quite another thing for an appraiser who is determining value. The IRS will need to address how these tests should be applied to valuation practice.

101.107 As discussed beginning at paragraph 1001.52, The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (2008 Act) further amended IRC Sec. 6694 (and IRC Sec. 7701) with respect to the definition of a tax preparer and the standards of conduct that tax return preparers must meet in order to avoid imposition of penalties. The Treasury and IRS issued final regulations reflecting these amendments.

101.108 Treasury Reg. 301.7701-15 clarifies who, as a return preparer, is subject to preparer penalties and provides definitions of *tax return preparer*, *signing preparer*, and *nonsigning preparer*. When the IRS issued the final regulations, it stated that it would "continue to include appraisers in the definition of both signing and nonsigning preparers, thereby providing the IRS with discretion to impose the Section 6694 and 6695A penalties in the alternative against an appraiser depending on the facts and circumstances of the appraiser's conduct. The IRS, however, will not stack the penalties under Sections 6694 and 6695A with respect to the same conduct."

101.109 Treasury Reg. 1.6694-2 reflects the changes to IRC Sec. 6694 made by the 2008 Act with respect to the definition of *unreasonable position* for determining tax preparer penalties. In general, a position is unreasonable unless there is *substantial authority* for the position. For a disclosed position (that is not a reportable transaction or tax shelter as defined in IRC Sec. 6662), the position is unreasonable unless there is a *reasonable basis* for the position. For an undisclosed position that is a tax shelter or reportable transaction, a position is unreasonable unless it is reasonable to believe that the position will *more likely than not* be sustained on its merits.

101.110 See the paragraphs beginning at 1001.50 for further discussion of penalties against tax preparers under IRC Sec. 6694.

101.111 **Paid Tax Preparer Registration** [11]

In 2010, the IRS Commissioner announced a new registration and competency testing regime for tax return preparers involved in the preparation of tax returns or, under certain circumstances, in the development of information to be included in the return. Currently, all paid tax preparers must have a preparer tax identification number (PTIN) before preparing returns.

101.112 Once registered, attorneys, certified public accountants, and enrolled agents who are active and in good standing with their licensing agency have no additional requirements other than to renew their PTIN annually. Likewise, supervised preparers and non-1040 preparers have no requirements other than to renew their PTIN annually. All other preparers will need to pass a competency test, renew their PTIN, and take continuing education courses annually. Those who already have a PTIN will have until the end of 2013 to take and pass the exam, but the continuing education requirement has already started.

101.113 Do Appraisers Need to Obtain a PTIN?.

While there is no official or definitive answer regarding whether appraisers need to obtain a PTIN at this time, the weight of the evidence strongly suggests that the IRS does not regard appraisers who provide only tax-related valuation services as return preparers. Thus, appraisers who provide only tax-related valuation services generally do not have to comply with the PTIN system requirements.

101.114 However, as mentioned in paragraph 101.103, the final IRS Rule on tax return preparer penalties under IRC Secs. 6694 and 6695 state that appraisers can be considered non-signing tax preparers if their appraised value constitutes “a substantial portion” of a tax return or claim for refund and the appraiser “knows or reasonably should know” that it represents “a substantial portion of the tax required to be shown. . . .” Notwithstanding the fact that appraisers can be regarded as non-signing preparers under these narrow circumstances, the IRS has drawn a clear distinction between tax practitioners (i.e., return preparers) and appraisers in the Circular 230 rules issued in June 2011. Additionally, the preparer registration program has been in effect for many months, and there has been a great deal of correspondence between IRS and the return preparer community regarding PTIN requirements. To the best of the authors' knowledge, no appraisers have received IRS communication as to why they have not registered.

101.115 Accordingly, at the present time there is no basis to believe that appraisers are required to obtain a PTIN unless they also prepare returns in their capacity as CPAs or as other eligible tax return preparers who sign returns. However, as this assessment is not definitive, practitioners should continue to monitor additional clarifications, if any, as they develop.

101.116 **Independence Issues With Audit Clients**

The Public Company Accounting Reform and Investor Protection Act of 2002, commonly referred to as Sarbanes-Oxley, contains a number of key provisions that require the Securities and Exchange Commission (SEC) to strengthen independence requirements for auditors of public companies. Specifically, Title II of Sarbanes-Oxley requires the SEC to adopt new rules that:

a. Prohibit certain nonaudit services.

b. Strengthen conflict of interest standards.

c. Strengthen audit partner rotation and second partner review requirements.

d. Enhance and clarify the relationship between the independent auditor and the audit committee.

101.117 Section 201(a) of Sarbanes-Oxley added Section 10A (g) to the Securities Exchange Act of 1934 to prohibit all registered public accounting firms from providing an audit client certain nonaudit services while named as the accountant of record. One of the nine prohibited nonaudit services specifically emphasized is appraisal or valuation services, including fairness opinions and contribution-in-kind reports. However, Sarbanes-Oxley does not prohibit an accounting firm from utilizing its own valuation specialist to review work done by the audit client or an independent, third-party specialist engaged by the audit client.

101.118 A number of states have adopted, or are considering adopting, certain rules similar to those of the Sarbanes-Oxley Act that are applicable for small and midsized nonregistered accounting firms. However, much of the state legislative activity to date has focused on areas such as the limitation or disclosure of non-audit services for an audit client and retention of audit workpapers. For example, the National Association of State Boards of Accountancy (NASBA) amended the Uniform Accountancy Act—UAA Model Rules to include a seven-year record retention requirement. The UAA rules are intended to provide guidance to state boards of accountancy in the form of a single uniform standard. Practitioners should be alert for changes in legislation in the states in which they operate. (See Appendix 1A-5, paragraph A.23 for further discussion of Sarbanes-Oxley.)

101.119 The Public Company Accounting Oversight Board (PCAOB) is under the supervision of the SEC to set auditing, quality control, ethics, independence, and other standards relating to the audits of public companies. The PCAOB has the authority to set standards governing the audits of public companies only; the AICPA continues to have the authority to set standards governing the audits of nonpublic companies and has actively developed and issued standards since the establishment of the PCAOB. [This *Guide* is not intended to provide guidance on compliance with PCAOB auditing standards. For audits of public companies or audits of nonissuers performed in accordance with PCAOB standards, auditors should consult *PPC's Guide to PCAOB Audits*. To order, call (800) 431-9025 or visit the PPC website at **tax.thomsonreuters.com**.]

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[1] The AICPA's Professional Ethics Executive Committee (PEEC) issued revisions to the guidance for maintaining independence when providing nonattest services (currently at ET 1.295). Effective for engagements covering periods beginning on or after December 15, 2014 these revisions help clarify that the preparation of financial statements is considered a nonattest service, regardless of whether the service was performed as part of an attest (audit, review, or compilation) engagement.

[2] In October 2014, Accounting and Review Services Committee (ARSC) issued SSARS No. 21, *Statements on Standards for Accounting and Review Services: Clarification and Recodification*, as the culmination of its clarity project. The new SSARS supersedes and revises the guidance of all

previous SSARS [except SSARS No. 14 (AR 120) for compiling pro forma financials.] Under the new SSARS, AR-C 80, *Compilation Engagements*, only applies to CPAs engaged to perform a compilation engagement, and a new section AR-C 70, *Preparation of Financial Statements*, applies to CPAs engaged to *prepare* financial statements. However, because AR-C 70 specifically exempts financial statements prepared as part of a valuation engagement from its scope, unless the CPA is specifically engaged to compile or review financial statements that also will be used as support in the CPA's separate valuation engagement, the CPA valuation consultant is not subject to SSARS. SSARS No. 21 is effective for engagements performed in accordance with SSARSs for periods ending on or after December 15, 2015, but early implementation is permitted. Once CPAs implement SSARS No. 21, they will need to determine whether they have been engaged to prepare or engaged to compile the historical financial information and follow the applicable standards for the appropriate service. Future editions of the *Guide* will be updated for SSARS No. 21.

[3] Much of this material is based on the article "AICPA BV Standards: The Former Chair Interviews the Current Chair" from *Financial Valuation and Litigation Expert*, Issue 16, December 2008/January 2009, published by Jim Hitchner's Valuation Products and Services, LLC (**www.valuationproducts.com**).

[4] Effective July 1, 2012, all but a few assets of the IBA were merged into NACVA or the new Appraisal Database and Mentoring Services (ADAM) division of NACVA. Although all members of the IBA were automatically transitioned to be member/subscription paying members of NACVA/ADAM, the IBA retained the unified standards under its own name and currently has over 350 members.

[5] This discussion is a summary of these rules. A complete copy of the regulations (16 CFR Part 313) is available at **www.ftc.gov/os/2000/05/65fr33645.pdf**.

[6] Described in Section 4(k) of the Bank Holding Company Act.

[7] In addition, USPAP also recognizes the GLB Act's privacy provisions in its discussion of confidentiality, by including a footnote that specifically mentions the GLB Act.

[8] On January 18, 2013, in *Sabina Loving et. al. v. Internal Revenue Service* [111 AFTR 2d 2013-589 (U.S. District Court, Dist. of Columbia, 2013)], the United States District Court for the District of Columbia halted the IRS from enforcing the educational and testing provisions of the revised Circular 230 that applied to registered commercial tax return preparers on the grounds that the Treasury Secretary's general authority to regulate practitioners is insufficient to permit such regulation. On February 1, 2013, the Court modified its order to clarify that it does not affect the requirement that all paid tax return preparers must obtain a preparer tax identification number (PTIN). In 2014, this decision was upheld by the Court of Appeals of the District of Columbia. However, Congress has since taken an interest in legislatively affirming the authority of the Treasury Secretary to regulate commercial tax return preparers.

[9] Although the June 2011 revisions to Circular 230 explicitly brought appraisers under its due diligence and sanctions provisions, it did not explicitly include appraisers in its (subsequently rescinded) educational and testing requirements that were to be applied to registered tax return preparers.

[10] *McCord* [461 F.3d 614, 98 AFTR 2d 2006-6147 (5th Cir. 2006)].

[11] In January 2013, a Federal Court in the District of Columbia in *Sabina Loving et. al. v. Internal Revenue Service* [111 AFTR 2d 2013-589 (U.S. District Court, Dist. of Columbia, 2013)] ruled that the IRS does not have the authority to regulate non-attorney, non-CPA tax preparers. On February 1, 2013, the Court modified its order to clarify that it does not affect the requirement that all paid tax return preparers must obtain a preparer tax identification number (PTIN). In 2014, this decision was upheld by the Court of Appeals of the District of Columbia.

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# 102 Education and Experience

102.1 Although many consultants already possess many of the skills needed to practice business valuation, additional training, experience, and support resources may be needed before the consultant can practice successfully on a wide array of valuation engagements. Before expanding into business valuation, the consultant should consider the following factors:

a. The consultant's existing capabilities.

b. Additional training that is needed.

c. How relevant experience will be gained.

d. What additional resources are needed.

e. How the new service will be marketed.

**Evaluate Capabilities**

102.2 A consulting firm may expand its practice to include business valuation services in one of three primary ways:

a. Develop the expertise in-house;

b. Hire an experienced appraiser from the outside; or

c. Form a strategic alliance with an existing valuation firm.

102.3 **Developing the Expertise without Prior Experience**

Even though this approach obviously requires a long lead time, a medium-size or large firm may develop a successful valuation practice in-house by designating someone in-house to become proficient and experienced in the subject. Ideally, the person chosen should be an experienced practitioner with sound business judgment and a strong knowledge of the tax and financial accounting issues faced by small businesses.

102.4 The probability of success of an internally developed valuation practice is greatly enhanced when the individual chosen to head up the practice is committed to its success and when the venture has the full support of the firm. The firm will usually invest significant sums in training costs and unassigned time during the development phase of a new practice, and it will often be several months before any revenues are generated. The partners should not expect a new practice to be profitable immediately.

102.5 After mastering the basic concepts of business valuation (see the discussion beginning at paragraph 102.10), the leader of the new practice should:

a. Recruit valuation staff either from within the firm or from the outside. (See further discussion at paragraph 102.27.)

b. Develop firm policies and procedures regarding valuation engagements as well as a comprehensive system of quality control.

c. Obtain library, computer, and other resources, and train the staff in their uses. (See the discussion beginning at paragraph 102.28.)

d. Develop and institute a marketing plan.

*PPC's Guide to Small Business Consulting Engagements* contains several chapters devoted to the development and administration of a new consulting practice. Consultants who wish to start a valuation practice will find this book to be an invaluable resource.

### 102.6 **Hiring an Experienced Valuation Consultant from the Outside**

Many firms feel that the easiest, most economical way to offer a new service is to hire experienced people from the outside. If the new consultant is able to bring new valuation clients to the firm, the service can have a more immediate impact on fee income. There are many variations of this approach, but two of the most popular are as follows:

a. The firm can hire an experienced appraiser at the partner or manager level and let that person develop the valuation department. This person may be able to quickly develop policies and procedures manuals and other materials that will allow the department to become productive within a short period of time.

b. The firm can purchase an existing business valuation company. This turnkey approach can be very efficient for accounting and other firms that want to begin offering this service immediately.

### 102.7 **Forming a Strategic Alliance with an Existing Valuation Consultant**

This approach is popular for small firms or for consultants that want to be able to offer valuation services without having to develop and maintain all of the required expertise in-house. Under this approach, a valuation consultant with a good reputation is identified. After performing extensive due diligence procedures on the experience and capabilities of the valuation consultant, an alliance is structured. There are many ways to structure such an alliance, but some of the more common include the following:

a. *Complete Referral.* The engaging consultant merely refers the valuation work to the valuation consultant and has no further involvement in the project. Since accountants and other professionals are often not able to receive commissions for business referrals, however, this method provides no direct monetary benefits to the CPA.

b. *Have the Valuation Consultant Issue the Report.* The project is staffed by the engaging consultant, but all work is reviewed and the report is actually issued by the valuation consultant. This method allows the engaging consultant to gain valuation experience while working under the direction of an experienced valuator.

c. *The Firm Issues the Report Using the Consultant's Staff.* Under this method, the valuation consultant's staff performs the valuation, and their work is reviewed by the engaging consultant, who issues the completed report. In effect, the accounting firm uses the valuation firm as a subcontractor. This method also allows the CPA to remain involved with the project while gaining additional valuation experience. This method is generally advisable only if the firm has an experienced staff or management member who can supervise and direct the outside consultant's staff. The legal liability issues of relying on another party's work should also be considered, along with the consequences of being asked to deliver expert witness testimony. (See also Principle 7.4 of the ASA's *Code of Ethics* and SSVS No. 1, paragraph 20.)

d. *As-needed Assistance.* The engaging consultant may only use the valuation consultant to review complex engagements or to provide guidance or insight whenever specialized industries are involved.

102.8 The AICPA has ethics rules for CPAs who outsource professional services to third parties.[12] The rules apply to consulting services, such as business valuation engagements, and include related clerical and data-entry functions. Under the rules, the CPA must do the following before disclosing confidential client information to the third party:

- Inform the client, preferably in writing, that the CPA consultant may use a third-party service provider to assist in providing the service to the client. If the client objects to the use of a third party, the CPA consultant must either provide the service without using the third party or decline the engagement. The engagement letter at VAL-PA-4 includes suggested language that can be used to inform the client.

- Enter into a contractual agreement with the third-party service provider requiring the party to maintain the confidentiality of the information and to have procedures in place to prevent unauthorized release of confidential information. If such an agreement is not obtained, the CPA must obtain the client's consent to disclose the client's confidential information to the third party.

102.9 The ethics rules also require the CPA consultant to do the following:

- Adequately plan and supervise the services provided by the third party.

- Obtain sufficient relevant data to support the work product.

- Comply with all technical standards applicable to the services.

### Training Requirements

102.10 Consultants who perform valuation services must be properly trained in this specialized field, even if the service is only offered part-time during a firm's slow seasons. Since many business valuation analysts come from different professional backgrounds, a number of organizations offer business valuation courses and, as indicated in Exhibit 1-3, award professional business valuation designations, some specifically developed for CPAs, attorneys, examiners, and other professionals. The following paragraphs discuss the major certifying organizations.

**Exhibit 1-3**

**Business Valuation Designations**

| Abbreviation | Name of Designation | Awarding Organization |
|---|---|---|
| ABV | Accredited in Business Valuation | American Institute of Certified Public Accountants (AICPA) |
| AIBA | Accredited by IBA | Institute of Business Appraisers (IBA) |
| AMPI | Accredited Member | American Society of Appraisers (ASA) |
| ASA | Accredited Senior Appraiser | American Society of Appraisers (ASA) |
| AVA | Accredited Valuation Analyst | National Association of Certified Valuation Analysts (NACVA) |
| BVAL | Business Valuator Accredited for Litigation | Institute of Business Appraisers (IBA) |
| CBA | Certified Business Appraiser | Institute of Business Appraisers (IBA) |
| CFA | Chartered Financial Analyst | Association for Investment Management and Research |
| CFE | Certified Fraud Examiner | Association of Certified Fraud Examiners |
| CPA | Certified Public Accountant | American Institute of Certified Public Accountants |
| CVA | Certified Valuation Analyst | National Association of Certified Valuation Analysts (NACVA) |
| CBI | Certified Business | International Business |

| | | |
|---|---|---|
| | Intermediary | Brokers Association |
| CFM | Certified in Financial Management | Institute of Management Accountants |
| CFP | Certified Financial Planner | College of Financial Planning |
| CMA | Certified Management Accountant | Institute of Management Accountants |
| EA | Enrolled Agent or Enrolled to Practice Before the IRS | Internal Revenue Service |
| FASA | Fellow of the American Society of Appraisers | American Society of Appraisers (ASA) |
| FIBA | Fellow of the Institute of Business Appraisers | Institute of Business Appraisers (IBA) |
| FCBI | Fellow Certified Business Intermediary | International Business Brokers Association |
| JD | Juris Doctor | Law schools around the country |
| MBA | Master of Business Administration | Various universities |
| MCBA | Master Certified Business Appraiser | Institute of Business Appraisers (IBA) |
| PhD | Doctor Philosophy | Various universities |

[SOURCE: Excerpt from "Explaining the Alphabet Soup: Business Appraisal Designation—What They Mean and How Difficult They Are to Obtain" by Paul R. Hyde. *Business Appraisal Practice*, Spring 2002. [a] Reprinted with permission from The Institute of Business Appraisers, Inc.]

**Notes:**

[a] Some business valuation designations have changed or been eliminated since the date this article was published. For example, as discussed in paragraph 102.23, the Institute of Business Appraisers has recently eliminated its Accreditation as Accredited-IBA (AIBA) and its Business Valuator Accredited for Litigation (BVAL) designations.

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102.11 **American Institute of Certified Public Accountants**

The AICPA has an accreditation program for CPAs performing business valuation services. The program results in the Institute granting an Accredited in Business Valuation (ABV) designation. To apply for the ABV program, an individual must be a member in good standing with the AICPA and hold a valid, unrevoked CPA certificate or license issued by a legal state authority. To qualify for the designation, a CPA must complete the following requirements:

a. Provide evidence of performing at least six business valuation engagements or at least 150 business valuation hours that demonstrate professional judgment, resulting in either a conclusion of value or a calculated value, or serving as a full-time instructor of a least four accredited college courses covering at least 50% of the material included in the ABV exam.

b. Complete at least 75 hours of CPE related to business valuations.

c. Pass an online exam which is offered at designated testing centers during periods in the Summer and Fall. [Candidates that hold the Accredited Senior Appraisers (ASA) or the Accredited Member (AM) credentials issued by the American Society of Appraisers are exempt from the exam requirements.]

102.12 To maintain the ABV accreditation, a CPA must complete 60 hours of related CPE during the same three-year period, of which only 24 hours may be in the form of writing articles and 36 hours may be in the form of lecturing, and electronically submit an intent of continued compliance with the recertification requirements. CPAs interested in participating in the program should contact the ABV Member Service Center at (888) 777-7077, or its website at **www.aicpa.org/InterestAreas/ForensicAndValuation/Pages/ForensicValuationHome.aspx**.

102.13 As discussed in paragraph 102.16, the AICPA and the American Society of Appraisers agreed to an education equivalency program that allows ABVs to receive credit for the ASA's four, three-day core courses in business valuation. Thus, for an ABV to receive the American Society of Appraisers' AM or ASA designations, the ABV must satisfy the ASA's experience and membership requirements, successfully pass an appraisal report and report review checklist through the peer review process, and pass an ASA ethics exam and the USPAP exam. See the paragraphs beginning at 102.14 for further discussion of the ASA's designations and qualification requirements.

102.14 **American Society of Appraisers**

The ASA offers an accreditation program for its members. To become a “candidate” for certification, the member must pass both the ASA Ethics exam and the Uniform Standards of Professional Appraisal Practice (USPAP) exam, and pass either four three-day courses in business valuation, including an exam following each course, or pass an 8-hour comprehensive exam. A description of each of these courses and the 8-hour exam is included on the ASA's website at **www.appraisers.org**. Candidates must also provide one comprehensive written business valuation report prepared for a client within the last two years and a completed ASA Candidate BV Report

Review Checklist. Eligible candidates can earn the following ASA business valuation professional designations:

a. An Accredited Member (AM) has at least two years of full-time or full-time equivalent valuation experience and a four-year college degree (or equivalent experience).[13] Full-time equivalent experience is based on the time spent on business valuation engagements. For example, if the consultant works on business valuation engagements 20% of the time, it will take five years to reach one year of full-time equivalent experience. In addition, the candidate must submit an acceptable appraisal report performed for an actual client within the last two years.

b. An Accredited Senior Appraiser (ASA) has fulfilled the same requirements as an Accredited Member but has at least five years of full-time or full-time equivalent valuation experience (one of which may be fulfilled by five years of CPA experience).

c. The designation in intangible asset valuation (IA) may be bestowed on an Accredited Senior Appraiser who completes two ASA intangible asset valuation courses and the related exams, submits an intangible asset report for review, and completes ten projects that involve the valuation of intangible assets. To obtain IA reaccreditation, designees must complete 20 hours of continuing professional education in addition to the standard ASA reaccreditation requirements discussed in the following paragraph.

d. The designation of Fellow (FASA) may be bestowed on an Accredited Senior Appraiser in recognition of outstanding service to the appraisal profession or the American Society of Appraisers.

102.15 Reaccreditation rules for ASA designations require the designees to complete 100 hours of continued professional education and/or organizational participation in professional activities every five years of which at least seven hours must be USPAP course work. (If less than 100 hours is obtained, reaccreditation for periods of two-four years may be obtained, depending on the number of CPE/participation hours completed during the current accreditation period.) Of the 100 hours, continuing education must comprise at least 40 hours. Continuing education may also include speeches, instruction, or other participation in an appraisal profession educational program, as well as published articles and other appraisal profession literary contributions.

102.16 The ASA and the AICPA have an education equivalency program that allows AICPA members with an Accredited in Business Valuation (ABV) credential to receive credit for the ASA's four three-day core courses in business valuation discussed in paragraph 102.14. Thus, for an ABV to receive the American Society of Appraisers' AM or ASA designation, the ABV must satisfy the

ASA's experience and membership requirements, successfully pass an appraisal report and report review checklist through the peer review process, and pass an ASA ethics exam and the USPAP exam. The ASA provides the same education waiver to members of the Institute of Business Appraisers (IBA) who hold the CBA and MCBA designations. (See paragraph 102.23 for further discussion of these IBA designations.)

102.17 Information about the ASA and its courses can be obtained at the following phone number and website:

American Society of Appraisers
(800) 272-8258
**www.appraisers.org**

102.18 **National Association of Certified Valuators and Analysts**

The National Association of Certified Valuators and Analysts (NACVA) provides education programs in business valuation and litigation support leading to the designation of Certified Valuation Analyst (CVA).[14] To qualify, an individual must be a CPA (or Canadian Chartered Accountant) or both hold a business degree and/or an MBA from an accredited college or university and satisfy NACVA's business valuation experience requirements. Individuals must be a member of NACVA, submit personal and business references, complete a 5-hour proctored exam, and complete a standardized case study (or submit an actual and sanitized fair value report, prepared in the last 12 months, for peer review).

102.19 NACVA also provides a financial forensic program that leads to the designation of Master Analyst in Financial Forensics (MAFF) credential.[15] The MAFF is for members who have a NACVA, AICPA, ASA, IBA, CPA, or certain other listed designations. The MAFF designation can be obtained by specializing in one of seven different areas of training: commercial damages and lost profits; forensic accounting; fraud risk management; business and intellectual property damages; bankruptcy, insolvency, and restructuring; business valuation in litigation; and matrimonial litigation.

102.20 MAFF applicants must satisfy the basic prerequisite experience requirement by showing involvement in 10 engagements or 1,000 hours in the specialty area. (However, 1,000 hours in business valuation services will suffice if 200 of the hours are in the applicable specialty area.) MAFF candidates must also satisfy the “foundational” experience requirement by showing lead involvement on 8 matters within the specialty area and providing 3 related presentations (including testimony in deposition or trial). Completion of certain NACVA classes or possessing the AICPA's Certified in Financial Forensics (CFF) credential will satisfy the foundational experience requirement. In addition to the experience requirements, MAFF candidates must complete a four- or five-day NACVA training program for the specific area of training selected and complete a proctored exam. Waivers are granted for the training course if the applicant can show further experience through involvement in 20 “matters” or 2,500 hours in the applicable specialty. (However, 2,500 hours in business valuation services will suffice if 1,500 of the hours are in the applicable specialty area.) MAFF designees must also complete 18 hours of specialty-area related training every three years as part of the 36 hour

CPE general recertification requirement discussed in paragraph 102.22.

102.21 An Accredited in Business Appraisal Review (ABAR) is granted to members who have a 4-year college degree or equivalent, submit 4 satisfactory professional references, complete a valuation report critiquing course, pass an examination on appraisal concepts and report review techniques, submit an appraisal review for peer review, and have a business appraisal designation from the IBA, AICPA, ASA, or NACVA. To retain the credential, ABAR designees must pay the NACVA member dues and fulfill the NACVA recertification requirements discussed below.

102.22 NACVA designations discussed in the previous paragraphs must be recertified every three years. Recertification requires the NACVA designees to obtain 36 hours of continued professional education (CPE) every three years, of which at least 18 hours must be in the area of business valuation. NACVA adheres to a "100-point system" that requires credentialed members to obtain at least 100 points every three years. One hour of CPE equals 1 point, but a 20 point "bonus" is awarded once the 36 hours of CPE have been obtained. In addition to the 56 points received for the 36 hours of CPE, members may obtain additional points through the following:

a. Participation in any of NACVA's five training NACVA programs, Knowledge of Current Development and Knowledge of Quality Issues, awards the designee "bonus" points and also provides hours towards the CPE requirement.

b. Professional development through authoring (books, articles, or instructional courses) or teaching/presenting valuation, litigation, or fraud related subjects qualifies for up to 25 points.

c. Experience gained through either performing valuation engagements or tasks/services that are characteristic to the valuation of an entity qualifies for up to 25 points. (A minimum of 1,500 hours in a three-year cycle is required.)

Additional information may be obtained at the following phone number and website:

National Association of Certified Valuators and Analysts
(800) 677-2009
**www.nacva.com**

**Institute of Business Appraisers**

102.23 The Institute of Business Appraisers (IBA) also conducts seminars on business valuation through NACVA's Consultant's Training Institute. The IBA's phone number and website are as follows:

Institute of Business Appraisers
(800) 299-4130
**www.go-iba.org**

The IBA awards the following professional designations: [16]

a. A Certified Business Appraiser (CBA) is for IBA or ADAM members who have a 4-year college degree or equivalent, complete two courses, submit personal and business valuation references, pass a written 5-hour examination covering the theory and practice of business valuations, and submit two acceptable demonstration appraisal reports. (Members who already hold ABV, ASA, CFA, MAFF, CBV, or CVA designations are exempt from the CBA exam and required courses.)

b. A Master Certified Business Appraiser (MCBA) designation is awarded through a review process. Applicants must have a 4-year college degree and 2-year post-graduate degree or equivalent, hold the CBA designation for at least 10 years, have 15 years of business appraisal experience, hold a professional designation from at least one other business valuation organization, and provide acceptable references from at least three other MCBA's or IBA Board members.

To retain accreditation for IBA designations, designees must obtain 36 hours of continued professional education every three years. Acceptable development includes attending classes or conferences sponsored by any business appraisal organization related to business appraisal, litigation, financial forensics, and fraud.

**Obtaining Relevant Experience**

102.24 A valuation consultant needs both training and experience to become proficient. Generally speaking, in business valuation, as in accounting, law, and other professions, the best experience is gained by working under the direction of a competent professional. This can be easily accomplished if a strategic alliance has been formed with a valuation firm as discussed in paragraph 102.7 or if the consultant has hired an experienced appraiser to head up the valuation practice. It can be difficult, however, if the valuation practice is started in-house without the assistance of any outside professionals.

102.25 Although all valuation engagements are complex and require a great deal of judgment, some have more exposure to criticism or liability than others. For example, an engagement to value an ownership interest for ESOP purposes involving complex valuation issues may have more exposure than an engagement to serve as an advisor for the seller of a business. A consultant should generally start with less complex engagements that have lower levels of exposure. A CPA firm that is already offering estate planning services, for instance, may begin performing the required estate tax valuations on small, less complex businesses in-house, then progress to more complex engagements.

**Resources That Are Needed**

102.26 The resources that a consultant typically needs to offer business valuation services largely fall into three categories: personnel, library, and computer hardware and software.

102.27 **Personnel Resources**

In starting a new valuation practice, a consultant can either develop the valuation staff from within or hire experienced appraisers from the outside. Regardless of which approach is used, certain common characteristics should be sought:

a. The valuation staff member should have a commitment to becoming a valuation professional. That means that the consultant must be prepared to attend training seminars and devote many hours of self-study to become a qualified business appraiser.

b. The valuation staff member should possess at least an undergraduate degree with a major in such areas as accounting and/or finance.

c. Since valuers must exercise a great deal of judgment in performing valuation services, the staff should have good business judgment and experience in critically reviewing financial information.

d. A potential staff member should have developed a certain amount of computer skills. A good candidate will have some experience in working with spreadsheet, data base, and word processing software.

102.28 **Library Resources**

Ideally, the professional business valuation practitioner should obtain the following library resources:

a. A reference library of books and articles providing authority and positions on all aspects of business valuation within the practitioner's defined scope of practice.

b. Economic and financial markets statistics and outlook information.

c. Publicly traded company information, including company descriptions, financial statement information, and stock prices.

d. Merger and acquisition prices and financial data.

e. Industry composite financial data.

f. File of relevant court cases (especially if the practice includes litigation support).

Appendix 1C is a list of books and periodicals that a practitioner should consider including in the firm's library. It is not necessary to purchase all of the titles listed in Appendix 1C. Many of these resources may be available at a public library that is convenient to the consultant's office.

102.29 **Computer Resources**

There is a wide range of general and specialized software available to the professional valuation practitioner. Most of this software runs on PC compatible hardware; however, some practitioners prefer to use Apple hardware or some other hardware platform.

102.30 Many appraisers use general software such as Microsoft Excel and Word to analyze data, perform calculations, and print reports. Over time, many practitioners develop proprietary software to facilitate their style of data analysis and presentation. There are also several computer programs available that have been designed to assist an appraiser in valuing a company. These programs can be of assistance in performing mathematical calculations using varying assumptions; however, these programs should be used with care. These programs do not replace the need for sound professional judgment on the part of the appraiser. Remember: people, not computers, do business valuations.

102.31 MoneySoft, Inc. offers a valuation software program, which closely follows the methodology discussed in this *Guide*. *MoneySoft Business Valuation Specialist* is a stand-alone application that is easy to learn and use. The software allows up to 10 years of historical and prospective financial statements and generates a draft version of the valuation report in Microsoft Word that can be easily modified. It is available at **http://moneysoft.com/business-valuation-software**. It also allows prospective financial statements to be prepared using individual line item assumptions. Thomson Reuters offers the *Done Deals* database at **www.donedeals.com** or it may be ordered by calling Thomson Reuters at (800) 431-9025.

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12 The rules are Ethics Ruling No. 112, *Use of a Third-Party Service Provider to Assist a Member*

*in Providing Professional Services*, under Rule 102; Ethics Ruling No. 12, *Applicability of General and Technical Standards When Using a Third-Party Service Provider*, under Rule 201 and Rule 202; and Ethics Ruling No. 1, *Use of a Third-party Service Provider to Provide Professional Services to Clients or Administrative Support Services to the Member*, under Rule 301. They may be accessed on the AICPA website at **www.aicpa.org**.

[13] CPAs can substitute five years of public accounting service for one of the required years of business valuation experience. A Chartered Financial Analyst (CFA) or a Certified Business Intermediary (CBI) is also entitled to the same waiver of one year of the business valuation experience requirement. However, only one total year of waiver is allowed, even if a person holds more than one of the eligible related designations.

[14] As of April 1, 2013, NACVA's Accredited Valuation Analyst (AVA) credential was merged into its CVA credential.

[15] As of April 12, 2013, NACVA's Certified Forensic Financial Analyst (CFFA) credential was changed to the Master Analyst in Financial Forensics (MAFF) credential.

[16] As discussed in paragraph 101.43, all but a few assets of the IBA were merged into NACVA or the new Appraisal Database and Mentoring Services (ADAM) division of NACVA.

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# 103 Overview of a Valuation Engagement

103.1 This section introduces the approach to conducting business valuation engagements recommended by the authors. Subsequent chapters discuss each aspect of this approach in detail. The approach is intended to provide a framework for the important engagement activities that are common to all valuation engagements. Exhibit 1-4 presents an overview of a typical business valuation engagement.

**Exhibit 1-4**

**Overview of a Business Valuation Engagement**

Recommended Quality Control Steps to Be Applied to a Valuation Engagement:

1. Evaluate whether to accept the engagement.

2. Prepare a work program.

3. Develop a time and fee estimate, if practical and possible.

4. When appropriate, obtain approval of the work program, staff assignments, and fee estimate.

5. When necessary, prepare a proposal letter or oral presentation.

6. Obtain an engagement letter.

7. Collect and adjust the data appropriate for the valuation methods used.

8. Perform the valuation methods under the supervision of an experienced individual.

9. Determine the final estimate of value. This usually involves the following procedures:

    a. Weighting of methods (whether quantitative or qualitative).

    b. Consider general “sanity checks” to the estimates of value.

    c. Applying premiums and/or discounts.

10. Document the work performed and conclusions reached.

11. Consider obtaining a representation letter, if possible.

12. Draft the valuation report.

13. Perform a detailed review of the workpapers and report draft.

14. If practical, obtain an independent internal review of the workpapers and report draft.

15. Resolve any professional disputes.

16. Discuss engagement findings and report draft with the client.

17. Determine that all review points and open items have been cleared.

18. Prepare the final report.

19. Sign the report or transmittal letter.

20. File the workpapers.

21. Evaluate the staff's performance.

**Note:** The authors recommend that the above procedures be considered when developing a firm's system of quality control. The firm's quality control system and the unique aspects of each engagement should dictate the specific procedures to be applied in an individual engagement.

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103.2 The specific procedures to be applied in a given valuation engagement will depend on two primary factors:

a. The firm's quality control system.

b. The unique aspects of each individual engagement.

There is little definitive guidance as to what specific procedures should be performed in a valuation engagement. Each firm generally has a great deal of flexibility in designing the procedures that will accomplish the valuation objectives of an individual engagement while conforming with the firm's quality control system. The suggested procedures listed in Exhibit 1-4 are often used by business valuation consultants in the order given and should be considered in designing work programs for valuation engagements.

**Overall Engagement Approach**

103.3 Business valuation engagements, like many services offered by accountants and other consultants, are conducted in the following three primary phases:

a. Pre-engagement and planning activities (discussed in Chapter 3).

b. Data gathering, analysis, and valuation procedures (discussed in Chapters 4-7).

c. Reporting and wrap-up (discussed in Chapters 8 and 9).

Each of the recommended quality control steps listed in Exhibit 1-4 falls into one of these three primary engagement phases. The remainder of this chapter presents an overview of the suggested steps and how they fit into the three phases of a typical valuation project.

**Pre-engagement and Planning Procedures**

103.4 Pre-engagement and planning activities include those procedures which are performed before the valuation fieldwork actually begins. The quality control steps that can be performed during this phase include the following:

1 Evaluate whether to accept the engagement.

2 Prepare a work program.

3 Develop a time and fee estimate.

4 When appropriate, obtain approval of the work program, staff assignments, and fee estimate.

5 When necessary, prepare a proposal letter or oral presentation.

6 Obtain an engagement letter signed by the firm and client.

103.5 **Evaluate Whether to Accept the Engagement**

A consultant should generally only accept engagements that can be completed professionally, within a reasonable time period, and for a reasonable fee. Before accepting a new valuation engagement, the consultant should, therefore, evaluate the client and the specific project. Among the factors that should be evaluated during this process are the following:

a. The consultant's professional competence.

b. The nature, risks, and requirements of the engagement.

c. Whether there are conflicts of interest and/or relationships that might appear to or actually impair the consultant's (1) objectivity or (2) credibility as an expert.

d. Whether the consultant is independent with respect to the client and subject business.

e. Other factors regarding the engagement, client, or the subject company.

The new client evaluation process is discussed in more detail in Chapter 3, which also introduces an “Engagement Acceptance Form” that can be used by valuation consultants. This form is included at VAL-PA-2.1.

103.6 In deciding whether to accept an engagement, the consultant should obtain a basic understanding of the subject company, its industry, its operations, and its historical operating results. At this stage, it is also important to obtain information regarding the valuation date or dates, the interest being valued, the reason for the valuation, and other information that will be required to understand the appropriate standard and definition of value. Some of this background information may already be available if the consultant has historically provided other services to the client. Chapter 3 provides a detailed discussion of the engagement acceptance process and introduces a “Company and Industry Background Information Form” that may be prepared during this pre-engagement phase. This form is included at VAL-PA-6.1.

103.7 Based on the information gathered during this phase, the consultant should be able to make a preliminary assessment of possible valuation methods to be used and any obvious difficulties in applying those methods. The consultant normally does not make a final selection of valuation methods until after all the data has been collected and analyzed. However, the experienced consultant can anticipate which methods are likely to be used and what problems, if any, there may be in applying those methods.

### 103.8 **Prepare a Work Program**

Once the necessary background information has been obtained and the overall valuation approach has been developed, the consultant can prepare a work program. Although the work program should be tailored to the unique circumstances of each engagement (including the level of detail), many procedures will be performed on virtually all valuation projects. The Practice Aids section of the *Guide* contains example work programs that can be modified to apply to most valuation engagements.

### 103.9 **Develop a Time and Fee Estimate**

After the work program has been prepared, a consultant can usually develop a fairly accurate budget for a valuation project. The budget should normally summarize the number of hours expected to be incurred for each staff level (staff, partner, reviewer, etc.). A fee estimate can be calculated by applying the appropriate hourly billing rates to the budgeted hours. The “Fee Estimate Worksheet” discussed in Chapter 3 can be adapted for use on most valuation engagements. This form is included at VAL-PA-3.1. In addition, a “Time and Resource Budget Form” that may be used by valuation analysts in industry can be found at VAL-PA-3.2. (The consultant may not always be able to develop a time and fee estimate, especially when litigation is involved.)

### 103.10 **When Appropriate, Obtain Approval of the Work Program, Staff Assignments, and Fee Estimate**

The planning and budgeting procedures of a valuation engagement are often performed by staff or manager level consultants. Before beginning the fieldwork, many firms, especially larger firms with more than one experienced valuation professional on staff, have a requirement that the work programs, staffing assignments, and time estimates prepared during the planning phase be reviewed and approved by a partner or other responsible party. Since the partner is usually the most experienced member of the engagement team, this review helps ensure that the valuation approach to be used will be the most effective and efficient.

### 103.11 **When Necessary, Prepare a Proposal Letter or Oral Presentation**

A consultant may occasionally have to compete with one or more other firms to obtain a valuation engagement. When this occurs, the engagement is typically awarded based in part on a written or oral proposal. Such proposals should stress the firm's qualifications, the expertise of the firm's personnel, the firm's ability to comply with completion deadlines, and a host of other matters. In addition to the brief discussion of proposals in Chapter 3, the consultant should consider referring to Chapter 4 of *PPC's Guide to Small Business Consulting Engagements* for a more in-depth discussion of this topic.

103.12 **Obtain an Engagement Letter**

By obtaining an engagement letter for each project, a valuation consultant can often avoid disputes resulting from client misunderstandings about the scope, timing, and cost of an engagement. The engagement letter should be signed by both the firm and the client. (The authors' suggest that valuation consultants not use an engagement letter that only requires the client's signature or that only requires the Firm's signature.) A properly drafted engagement letter will also explain the extent of responsibility the consultant takes for historical and projected financial information supplied by the company being valued. If the appraisal ultimately may involve litigation, the attorney may want to engage the consultant in order to protect his work product until the attorney can decide whether or not to name the consultant as an expert witness. Example engagement letters can be found at VAL-PA-4.1 and VAL-PA-4.3.

**Data Collection, Analysis, and Valuation Procedures**

103.13 During this phase, the consultant should perform the procedures outlined in the work program previously discussed. In general terms, these procedures require the consultant to perform the following steps from Exhibit 1-4:

7 Collect and adjust the data appropriate for the valuation methods used.

8 Perform the valuation methods under the supervision of an experienced individual.

Although these steps will be discussed in more detail in Chapters 4-7, a brief overview is presented in the following paragraphs.

103.14 **Collect Data Appropriate for the Valuation Methods Used**

In order to establish a value for a company, a consultant must generally gather a great deal of information about the company, its industry, the economy in which the company operates, and other guideline companies. To be useful, the information must be timely, accurate, and comparable to similar companies against which comparisons will be made. This information is usually gathered during the early stages of the valuation engagement.

103.15 The specific types of information needed will vary from engagement to engagement and are primarily based on the valuation methods that are appropriate for a particular project. The data gathering process usually involves an analysis of historical financial information, interviews with company management, and extensive research on guideline companies, economic and industry trends, and market price data. Financial information must often be adjusted and analyzed before it can be used in the valuation process. Comprehensive data gathering checklists and questionnaires are presented in the Practice Aids.

103.16 **Perform the Valuation Methods under the Supervision of an Experienced Individual**

To ensure that the valuation procedures are performed effectively and efficiently, the valuation staff must be properly supervised throughout this phase of the engagement. This supervision should extend to staff members employed directly by the consultant, subcontractors who perform certain portions of a valuation engagement, and employees of valuation firms with which the consultant works under a strategic alliance as discussed in paragraph 102.7.

**Reporting and Wrap-up Procedures**

103.17 The final phase of an engagement involves the preparation and issuance of the valuation report and completion of a number of administrative items. The procedures normally performed during this phase as listed in Exhibit 1-4 include:

9 Determine the final estimate of value. This usually involves the following procedures:

a. Weighting of methods (whether quantitative or qualitative).

b. Consider general *sanity checks* to the estimates of value.

c. Applying premiums and/or discounts.

10 Document the work performed and conclusions reached.

11 Consider obtaining a representation letter, if possible.

12 Draft the valuation report.

13 Perform a detailed review of the workpapers and report draft.

14 If practical, obtain an independent internal review of the workpapers and report draft.

15 Resolve any professional disputes.

16 Discuss engagement findings and report draft with the client.

17 Determine that all review points and open items have been cleared.

18 Prepare the final report.

19 Sign the report or transmittal letter.

20 File the workpapers.

21 Evaluate the staff's performance.

These procedures are discussed in detail in Chapters 8 and 9. The following paragraphs provide a brief overview of these steps.

103.18 **Determine the Final Estimate of Value**

As discussed in more detail in Chapter 8, this step usually involves the following procedures:

a. A valuation consultant often uses two or more valuation methods to estimate a company's value. This usually results in a range of possible values, which the consultant must often narrow down to a single value. This is normally accomplished by subjectively or mathematically weighting the values computed using the different valuation methods.

b. The value estimate should be tested for reasonableness considering one or more general *sanity checks.*

c. The consultant should *adjust* the resulting value by applying any appropriate premiums and/or discounts. These typically may include minority interest discounts, control premiums, and discounts for lack of marketability. (Note that most of these adjustments are usually considered in the cash flows, so minority interest discounts and control premiums may not be necessary.)

103.19 **Document Work Performed and Conclusions Reached**

A consultant should prepare a set of workpapers for each valuation engagement. The workpapers should include not only the completed work programs, but also all data, calculations, and key assumptions made by the engagement team, as well as the conclusions reached.

103.20 **Consider Obtaining a Representation Letter (If Possible)**

Auditing standards require that CPAs obtain representation letters from audit clients. In such letters, the companies being audited make various statements (representations) regarding the accuracy and completeness of company information used by the auditor. It is sometimes useful to obtain similar representation letters during business valuation engagements. Although this is not a required step on all valuation engagements, the consultant may desire to obtain such written representations in some situations. Paragraph 66 of SSVS No. 1 (VS 100.66) addresses representation letters. An example representation letter can be found at VAL-PA-17.1 and VAL-PA-17.2.

103.21 **Draft the Valuation Report**

The results of a valuation project are usually communicated to the client in a written report. Note that written reports may not be required in all valuations (such as those in a litigation setting). The format of a typical written report and the information that should be included in it are discussed in detail in Chapter 9. A checklist of all required and desirable report features is also provided at VAL-PA-16.1.

103.22 **Perform a Detailed Review of the Workpapers and Report Draft**

The workpapers used to document a valuation engagement and the report draft should be reviewed for accuracy, completeness, and compliance with firm and professional standards. Completion of the review can be documented either by initials on the workpapers or by completion of a reviewer's checklist or memo. An “Engagement Review Checklist” is included at VAL-PA-18.

103.23 **If Practical, Obtain an Independent Internal Review of the Workpapers and Report Draft**

Many consultants have a requirement that the engagement workpapers and final report draft be reviewed by a member of the firm who has no other responsibility for the engagement. An independent review helps ensure that the engagement team has followed the firm's quality control procedures and provides an additional check for errors or inconsistencies in the valuation report.

103.24 **Resolve Any Professional Disputes**

A great deal of judgment must be exercised in conducting a business valuation engagement. This sometimes leads to professional disputes between staff members over the interpretation of some of the data used in the valuation process. Each consulting firm should design procedures to follow when professional disputes occur.

103.25 **Discuss Engagement Findings and Report Draft with the Client**

Before concluding an engagement and issuing the final report, the consultant should usually meet with or talk to the client to discuss the engagement findings and report draft. Such a discussion can be helpful both for the client and the consultant. The client can often obtain a better understanding of the engagement findings by asking the consultant questions during this face-to-face meeting or phone conversation. The client may also be able to provide additional information to the consultant that can be useful in further supporting or, in some cases if appropriate, modifying the valuation conclusion based on new information not previously known.

103.26 **Determine That All Review Points and Open Items Have Been Cleared**

Review comments and pending notes are often written throughout an engagement. An engagement cannot be considered completed until all such matters have been addressed by the engagement team to the satisfaction of all parties. A final valuation report should never be issued until all comments and pending notes have been cleared.

103.27 **Prepare the Final Report**

At this point, the consultant should be able to prepare the final valuation report. Obviously, information that was obtained from the discussion with the client and during the workpaper and report reviews should be properly addressed in the final report.

103.28 **Sign the Report or Transmittal Letter**

Most consulting firms specify that a partner or other responsible party sign all final reports or transmittal letters. Before signing the report or transmittal letter, the partner should determine that all required engagement procedures have been completed, that all review comments and pending notes have been cleared, and that the independent review, if practical, has been performed.

103.29 **File the Workpapers**

At this point, the consulting project has been completed, and the workpapers should be filed for future reference. Some firms have procedures that require the engagement workpapers to be filed in a standard sequence. Also, some firms (based on advice from their legal counsel) have policies requiring that all review points on (and certain documents used in) the engagement be discarded before the workpapers are filed.

103.30 **Evaluate the Staff's Performance**

The performance of the consulting staff should be evaluated at the end of each engagement. The evaluation may be communicated orally or in writing to the individual staff member(s). However, if the evaluation is in writing, the completed form should be discussed with the staff member before being filed in the employee's personnel file.

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# 104 Calculation Engagements

104.1 Calculation engagements are a relatively new type of engagement for CPA valuation consultants to consider. SSVS No. 1 and the NAVCA/IBA professional standards are the only valuation standards that explicitly address calculation engagements (although, as discussed later in this section, the ASA Business Valuation Standards address the performance of a *Calculation*. SSVS No. 1 (VS 100.21) defines a *calculation* engagement as follows:

> A valuation analyst performs a calculation engagement when (1) the valuation analyst and the client agree on the valuation approaches and methods the valuation analyst will use and the extent of procedures the valuation analyst will perform in the process of calculating the value of a subject interest (each procedure will be more limited than those in the valuation engagement) and (2) the valuation analyst calculates the value in compliance with the agreement. The valuation analyst expresses the results of these procedures as a calculated value. The calculated value is expressed as a range or as a single amount. A calculation engagement does not include all the procedures required for a valuation engagement.

104.2 Because the agreed-upon procedures are more limited than those of a valuation engagement, the valuation consultant calculates the value using the procedures agreed upon with the client. For example, to limit the fees associated with a valuation, a manufacturing company may request a calculation engagement by instructing the valuation consultant to not consider the market approach, but to use the capitalized cash flow method and the net asset value method, without obtaining current appraisals on the entity's fixed assets. Because a valuation engagement would normally include considering the market approach and, if applicable, obtaining recent fixed asset appraisals for the equipment, this engagement would qualify as a calculation engagement rather than a valuation engagement. Thus, calculation engagements do not include all of the procedures that would be considered necessary in a valuation engagement.

104.3 Due to the reduced scope of a calculation engagement, the valuation analyst generally spends less time and effort determining a calculated amount, resulting in lower fees for the client. However, many clients may desire a calculation engagement due to the reduced price without understanding the difference between a calculation engagement and a valuation engagement. The client may profess an understanding while still maintaining the expectation of receiving a valuation conclusion at a reduced price. Therefore, it is important that the valuation analyst clearly explain the differences between the two types of engagements within the context of the client's specific circumstances. It is preferable to obtain a written understanding of the client's understanding through an engagement letter.

104.4 Because the focus of this *Guide* is business valuation, calculation engagements are not covered extensively. However, the remainder of this section discusses the applicability of calculation engagements under USPAP, the pros and cons of calculation engagements, and tips for performing calculation engagements. Also, section 905 discusses the reporting requirements for calculation engagements, Appendix 9C provides an illustrative calculation report, and VAL-PA-4.2 provides a “Sample Calculation Engagement Letter Drafting Form.”

**Is the Performance of a Calculation Engagements in Compliance with USPAP?**

104.5 As discussed in paragraph 104.1, SSVS No. 1 (SSVS 1), the NAVCA/IBA professional standards, and the ASA Business Valuation Standards allow for a level of service known as a calculation engagement or a calculation. Similar to the SSVS No. 1 definition of a calculation engagement (see paragraph 104.1), the ASA Business Valuation Standards, BVS-1: General Requirements for Developing a Business Valuation, discusses the performance of a calculation as follows:

> a. The objective of a calculation is to provide an approximate indication of value of a business, business ownership interest, security or intangible asset based on the performance of limited procedures agreed upon by the appraiser and the client.
>
> b. A calculation has the following qualities:
>
> > (1) Its result may be expressed as either a single dollar amount or range.
> >
> > (2) It may be based upon consideration of only limited relevant information.
> >
> > (3) The appraiser collects limited information and performs limited analysis.
> >
> > (4) The calculation may be based upon conceptual approaches agreed upon with the

client.

c.

104.6 Many practitioners have asked, “Can I do a calculation engagement as prescribed in AICPA SSVS No. 1 (SSVS 1) and be in compliance with USPAP?” It is the authors' opinion that a practitioner can, with certain caveats, perform a calculation engagement and report the results in compliance with USPAP. However, although it is possible to perform a calculation engagement in accordance with USPAP, the authors do not necessarily recommend such an engagement, especially in a litigation setting. The following paragraphs support the authors' opinions.

104.7 Given the increasing cost of valuation services many stakeholders have requested, under certain circumstances, a level of service less than an estimate of value that uses appropriate procedures required in a valuation engagement. As a result, the AICPA's SSVS 1 (VS 100.21) and the American Society of Appraisers' (ASA) BVS-1 allow for a calculation engagement or a calculation, respectively.

104.8 As discussed in paragraph 104.1, in a calculation engagement subject to SSVS 1, the valuation analyst and the client agree on the specific valuation approaches and methods the valuation analyst will use and the extent of valuation procedures the analyst will perform to calculate the value of the subject interest. A calculation engagement does not include all of the procedures required in a valuation engagement as that term is defined in SSVS 1. Thus, SSVS 1 requires the following clause in the body of the calculation report: *Had a valuation engagement been performed the results might have been different.*

104.9 The ASA's calculation level of service is more ambiguous. Under BVS-1, the objective of a calculation is to provide an approximate indication of value based on the performance of limited procedures agreed upon by the appraiser and the client.[17] (Note that under ASA's Professional Standards and Ethics Administrative Rule IV, the entire membership of the society individually and collectively should observe USPAP unless the practice is in Canada or solely outside of North America. AICPA, NACVA and IBA members have no such requirement.)

104.10 USPAP Standard 9, *Business Appraisal Development*, does not explicitly address calculations as a type of appraisal. Rather, an appraisal is an opinion of value reached as a result of a variety of scopes of work. The level and extent of the scope of work given the intended use and intended user is more fully described in the Scope of Work Rule, one of the five basic rules required by USPAP.

104.11 USPAP defines *scope of work* as the type and extent of research and analysis in an appraisal or appraisal review assignment. The Scope of Work Rule was introduced for the purpose of allowing the use of various levels of research. [17] Accordingly, under USPAP, both a valuation engagement and a calculation engagement would be considered appraisals but with different scopes of work.

104.12 Under USPAP, a calculation engagement would be an appraisal with a lesser scope of work than a valuation engagement. The practitioner would need to determine that the lesser scope of work would be appropriate for the intended use. In addition, the lesser scope of work would have to produce conclusions (assignment results under USPAP) that would be credible.

104.13 **Practical Applications**

A typical situation where a client might request a lesser scope of work under a calculation engagement would be in a litigation setting where settlement talks are ongoing and the client requests calculations, so they can get an idea of the value. In this circumstance, if the practitioner does perform a calculation engagement, but the matter does not end in a settlement and testimony is required, the practitioner may face difficulties in court. For example, the practitioner would likely have to testify about the completeness of the assumptions supporting the calculated value, the credibility of the calculated value, and why a valuation engagement was not performed.

104.14 Although there have been instances where the results of a calculation engagement have been used in testimony, it is not recommended. In the situation described above the expert should ensure that the client understands that a different level of work would be required and that the results of the calculation may differ from the results of a more thorough valuation engagement.

104.15 Therefore, while a calculation engagement may be in compliance with USPAP, the intended use as the basis of testimony would most likely not be appropriate. Under any circumstances, the practitioner should not misrepresent what was provided and the scope of work performed.

**Pros and Cons of Calculation Engagement**

104.16 As discussed in paragraph 104.3, attractive aspects of a calculation engagement include the reduced cost to the client and the reduced scope, effort, and time for the valuation analyst. Calculation engagements are also beneficial in situations when (in the analyst's professional judgment) the circumstances dictate that only a certain valuation method may be relevant to value the subject interest. Calculation engagements are also effective as a less expensive means to possibly settle a litigation dispute without going to court.

104.17 However, calculation engagements also have shortcomings. As discussed in paragraph 104.3, clients often do not understand the difference between a calculation engagement and a valuation engagement. This lack of understanding could harm the effectiveness of the engagement and perhaps the reputation of the analyst if the analyst does not take the time and effort to explain the differences between the engagements and potential future implications of choosing a particular engagement.

104.18 Similarly, the valuation analyst must specifically define the valuation procedures and effectively communicate them to the client. The analyst must also be certain that the client understands and agrees to the valuation procedures. Also, third parties may not know the difference between a calculation engagement and a valuation engagement and assume the calculated value is the analyst's valuation conclusion.

104.19 In certain circumstances, such as in divorce litigation, the analyst may have to subsequently inform the client that a calculation engagement is no longer sufficient and that a (more expensive) valuation engagement is necessary. Other negatives aspects of performing calculation engagements in a litigation setting include the following:

- The calculation value may be blurred with a conclusion of value in an attempt to make the analyst state that the calculated value is actually a conclusion of value.

- The valuation analyst may face the unpleasant task of explaining why only a calculation report was provided (particularly if the other side produced a valuation report).

- The valuation analyst may have to acknowledge and defend why a calculation engagement does not include all of the procedures required for a valuation engagement and had a valuation engagement been performed, the results may have been different. (This information should be included in a calculation report. See item c. of 905.3.)

- Perception of a lower level of service could tarnish the calculation value and even the credibility of the analyst.

- Confusion of whether a calculated value can be supported as an opinion of value with reasonable certainty.

104.20 **Tips for Performing a Calculation Engagement**

To minimize the potential drawbacks of calculation engagements, valuation analysts should consider the following practices when performing calculation engagements:

- The calculation engagement letter should clearly state the procedures previously agreed upon with the client. In addition, it may be prudent to disclose what approaches, methods, and procedures were not used.

- Include a caveat in the calculation engagement letter specifying that a valuation engagement (for a higher fee) may be required at the discretion of the analyst, particularly if the valuation analyst is asked to testify.

- Provide the calculated value as a range instead of a single amount.

- A calculation engagement in a litigation setting may be viewed more favorably if both sides agree to do so.

- In a court room setting, clearly define the reduced scope of the calculation engagement used to determine the calculated value.

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[17] For additional discussion of this issue, see Carla G Glass, “The Question of Calculations and USPAP- Another Round”, FVLE Issue 47 February/March 2014 and Jim Hitchner, “Calculations and Opinions Bringing Clarity to a Cloudy Issue”, FVLE Issue 50, August/September 2014.



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