Jim Hitchner's Valuation Products and Services

VPS Q&A

A free Q & A periodical to promote education, build consensus and answer your questions in the financial valuation and litigation services industry.

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REPORTING AND STANDARDS FOR VERY SMALL BUSINESSES

Question 1: Under the AICPA's Statement on Standards for Valuation Services (SSVS), what business valuation reporting options are appropriate in rendering a value for a small business owner's estate that only requires a probate filing? The business has sales of 180k, net income of 30k, book value of 120k, officer's salary of 34k and possible intangible asset and goodwill. Obviously a detailed business valuation report would be best, however it is the most costly option. What do you recommend in this type of situation?

Answer 1: First, let's distinguish between reporting and the type of valuation engagement being performed. Under the SSVS, the engagement can be either a valuation engagement or a calculation engagement. Since the implication is that the report must accompany the probate filing, it would seem logical that a calculation, which does not provide a conclusion of value, would not be appropriate. Assuming then that a valuation engagement is performed, I don't see any reason why the summary report could not be used instead of the detailed report in this situation. The work performed is the same for either report and the summary report still has to be coherent to the reader.

Under USPAP there is no standard for a summary report. Standard 10: Business Appraisal, Reporting of USPAP presents only two written reporting options: Appraisal Report and Restricted Use Appraisal Report. In the USPAP 2008-2009 edition from The Appraisal Foundation, Standards Rule 10-2, page U-72 states: "Comment: When the intended users include parties other than the client, an Appraisal Report must be provided. When the intended users do not include parties other than the client, a Restricted Use Appraisal Report may be provided. The essential difference between these options is in the content and level of information provided. The appropriate reporting option and the level of information necessary in the report are dependent on the intended use and intended users."

It is more complicated then just this quote but the bottom line is that there is no direct standard for a summary report under USPAP. However, while USPAP tells you what should be included in a report they do not tell you how much to write. Standards Rule 10-1, page U-72 states that the appraisal report must: "contain sufficient information to enable the intended user(s) to understand the report…"As such, as long as you cover what they say you should, there is no prohibition against being concise but still understandable.

Answer by: Jim Alerding, CPA/ABV, ASA, CVA, Clifton Gunderson, LLP (Indianapolis), one of only four members of the AICPA Business Valuation Standards Writing Task Force and served for the entire six years up to the June 2007 official release of the standards. jim.alerding@cliftoncpa.com

THE WACC IN FAIR VALUE FOR FINANCIAL REPORTING

Question 2: The WACC includes weighting common equity, preferred equity, and debt. Yet, in fair value for financial reporting purposes, only common equity and debt are used as "guideline-market" rates [e.g. from Ibbotson's cost of capital industry statistics]. Why isn't preferred equity used?

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Answer 2: For financial reporting, the definition of fair value is defined as a transaction between "market participants." If the analyst determines that market participants would develop a rate of return based on a weighted average cost of common equity and debt, to the exclusion of preferred, the analyst should use only debt and equity in developing the WACC. Generally, if one consults Ibbotson or actual guideline comparables, one finds common and debt but typically not preferred.

Answer by: Steve Hyden, CPA/ABV, ASA, The Financial Valuation Group (Tampa), coauthor of Valuation for Financial Reporting, Fair Value Measurements and Reporting, Intangible Assets, Goodwill and Impairment, 2nd edition, 2007, Wiley. shyden@fvgfl.com

DEBT AND INVESTED CAPITAL

Question 3: When subtracting debt from invested capital to arrive at the value of equity, you use the terms "interest bearing debt" and "long-term debt" interchangeably. Can you clarify if you feel that just long-term debt should be subtracted from invested capital or if you would include all interest bearing debt (short term, line of credit)?

Answer 3: You can use either, but I usually use all interest bearing debt, including short term and capital leases. We find it easier. Consistency is key. If you are calculating multiples or D/E weights from public companies, whatever debt level you use in those public company calculations is what you subtract from the subject company to derive equity. Also, the debt that is subtracted from the subject company is the actual debt of the company.

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