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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MORNINGSTAR (IBBOTSON) SIZE PREMIUM DATA

Question 1: I hear that there are problems with using Morningstar (previously Ibbotson) category 10b when determining a size risk premium in the build up or modified capital asset pricing model when calculating the cost of equity for a smaller company. Should I use 10b data?

Answer 1: The selection of a size premium is up to each individual analyst. However, the analyst should be ready to defend that selection and understand how the size premium he/she uses is calculated as well as the data that goes into the premium. Furthermore, the analyst should also be ready to answer the following question: "Why didn't you use the other possible choices for the size premium?" Morningstar publishes many types of size premiums for smaller companies, including the micro-cap, which is a fancy term for the 9th and 10th deciles combined, the 10th decile, and categories 10a and 10b. The difference in the size premium between decile 10 and category 10b has recently been around 3 percent to 4 percent, a substantial amount. Obviously, the 10b category includes the smallest companies as measured by the sole criteria Morningstar uses, market value of equity. This is where many analysts criticize the use of category 10b data.

In Morningstar's *Stocks, Bonds, Bills and Inflation, 2008 Yearbook, Valuation Edition, (SBBI 2008) www.global.morningstar.com/DataPublications*, pp. 130, 138, the range of the size of equity of the 1,405 companies in 10b is $1.9 million to $212 million, with a mean average of $102 million. However, using the market value of equity as a measure of size can be deceiving. First off, how often do you think a $1.9 million company trades? So that's a potential problem. However, what is really enlightening are the types of companies in 10b, particularly when viewed from the perspective of other measures of size.

In *Cost of Capital Applications and Examples, Third Edition*, Shannon P. Pratt and Roger J. Grabowski, 2008, John Wiley & Sons, Inc. (COC3), Chapter 13, "Criticisms of the Size Effect," pages 209-219, there is a very good presentation and discussion of the data that makes up Morningstar's category 10b. The information is from the *SBBI Valuation Edition 2006 Yearbook*. The median market value of equity and sales for category 10b was $54 million and $28 million, respectively. However, *COC3* presents the largest ten companies in 10b as measured by sales and the range is $795 million to $2.269 billion. Furthermore, the $2.269 billion company has a market value of equity of $92 million. Chapter 13 of *COC3* has other examples of the disconnect between size as measured by market value of equity and size as measured by a different criteria.

Regardless of what size premiums or other risk premiums analysts choose to use, the bottom line here is that analysts who use Morningstar data must read the book. Morningstar does a very good job presenting and explaining the data, and the book is written in a very understandable manner. In terms of the sections on equity risk premiums, size premiums and industry risk premiums, it is a relatively easy, short but important read. The days of just taking the data from the last page without an understanding of that data are over, particularly in the litigation area. Reading the book, particularly the sections on risk premiums, is a low investment of time with a big return on that investment.

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[*Editor's Note:* Jim Hitchner was a reviewer for *COC3* and strongly encourages analysts to review this important book, particularly the chapters on risk premiums. He thinks this book is the most comprehensive book on cost of capital he has ever seen. (See Jim Hitchner's book review in the next edition of *Financial Valuation and Litigation Expert* www.valuationproducts.com.) Jim Hitchner has also been in contact with James Harrington, Director, Business Valuation Research, Individual Investor Unit, Morningstar, Inc., who has informed him that Morningstar is considering several changes to the *SBBI 2009 Yearbook*, Valuation Edition, including additional size breakouts (perhaps as many as five) of decile 10, the removal of distressed companies and additional measures of size. Assuming these changes are made, the *2009 Yearbook* will be another must-read and will give analysts more tools and information to work with.]

VALUATION/APPRAISAL REVIEW OF ANOTHER ANALYST'S WORK

***Question 2:* Must valuation analysts comply with SSVS when reviewing the work and/or report of another valuation analyst?**

Answer 2: First off, obviously a "review" of another analyst's work and/or report is not an attest function. Also, "appraisal review" has a special meaning within the Uniform Standards of Professional Appraisal Practice (USPAP), particularly Standard 3, "Appraisal Review, Development and Reporting." If you are a CPA and a member of the AICPA and also belong to an organization that requires compliance with USPAP, e.g., ASA, you should follow Standard 3. Also, under Standard 3 if you conclude to a value you are then subject to Standard 9, "Business Appraisal, Development" and Standard 10, "Business Appraisal, Reporting." If you are not required to follow USPAP and are required to follow *SSVS*, there is no section of *SSVS* that discusses the review of another analyst's work and/or report. There is nothing to comply with, since *SSVS* is silent on this area.

However, if you "review" the work and report of another analyst and use that information to estimate your own value, SSVS will apply under the following conditions within para. 4 of *SSVS*: "In the process of estimating value as part of an engagement, the valuation analyst applies valuation approaches and valuation methods, as described in this Statement, and uses professional judgment. The use of professional judgment is an essential component of estimating value." The bottom line here is if you "review" another analyst's work and/or report and use that information and review process to apply valuation approaches and methods and use professional judgment to conclude to a value, you must comply with *SSVS*. If you are performing this "review" without those components, then *SSVS* is silent on the issue.

Answer by: Jim Alerding, CPA/ABV, ASA, CVA, Clifton Gunderson, LLP (Indianapolis), former member of the AICPA BV Standards Writing Task Force, *jim.alerding@cliftoncpa.com*.

CORPORATE DIRECTOR COMPENSATION SOURCE

***Question 3:* Do you know of any sources or surveys of director's compensation? Specifically, we are trying to determine a reasonable compensation (fee) for a board chairman who does not work at the subject company.**

Answer 3: Try the National Association of Corporate Directors (NACD). NACD is an independent, not-for-profit membership organization, serving the corporate governance needs of directors of public, private, and non-profit organizations. NACD conducts independent research and publishes an annual "Director Compensation Report." You can order it from their website at *http://www.nacdonline.org.*

Answer by: Eva Lang, CPA/ABV, ASA, the Financial Consulting Group (Memphis), coauthor of The Best Websites for Financial Professionals, Business Appraisers and Accountants, Wiley, *elang@gofcg.org.*

COMPENSATION ADJUSTMENTS IN VALUATION

Question 4 **I have heard attorneys state that in many valuations, appraisers act as compensation consultants without a license, i.e., using various studies that may not tell the whole story. Do you agree?**

Answer 4: There is increasing emphasis being placed on support for compensation-related determinations within business valuations. My first reaction to the question focuses on what the definition of a "compensation consultant" is in the context of being challenged to justify the work. I am not familiar with any authoritative credentials or designations that specifically relate to litigation-oriented compensation consulting, although there are numerous firms that specialize in compensation studies and related matters.

Determining the equivalent of the economic cost to replicate the services of the owner-employee on an arm's length basis can result in huge differences in the underlying opinion of value. We have been involved in matters where this one element is the linchpin of the overall differences in opinions between us and another reputable business appraiser. We have also been involved in lost wage economic damages and tax matters where the same fundamental principles apply. It is the delicate balance between drawing on all available and relevant objective data and the necessary application of judgment based on a thorough analysis of all the relevant facts, which creates the opportunity for questions (e.g. cross examination) on how the subject compensation determinations were made.

For the types of efforts outlined above, we do not hold any specific designations or credentials that specifically relate to compensation consulting per se. Much of our ability and standing to render opinions in this area draws upon the years of professional experience as certified public accountants and analysts, having worked with hundreds, if not thousands, of closely held businesses. Almost always, these are situations where the owner-employees maintain control over compensation decisions and therefore, have the ability to set their respective salaries and

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benefits at whatever level is supportable economically by the enterprise. This is coupled with such decisions being made based on tax planning strategies, which often have no bearing on what the owner-employee is actually worth to the enterprise.

There are a number of established and emerging databases available to assist the valuation analyst in determinations of reasonable compensation for owner-employees. This gets at the heart of the question: while some of these resources are well recognized and statistically sound, others are somewhat suspect. Given the significant impact a reasonable compensation determination can have on an appraisal conclusion, it is obvious why challenges develop. I have personally endured lengthy cross examinations focusing on my conclusions as they relate to normalized compensation within appraisal assignments. In all cases, where I have exercised prudent judgment, relied on and understood the data from recognized sources, without overreaching in the underlying conclusions, my testimony and opinions have withstood such challenges. If you invest the time needed in the research and developmental aspects of building proper support for this often subjective area of our work, your conclusions should be fine. The same can be said for protecting your professional standing as a valuation analyst who is competent and qualified to make reasonable compensation determinations.

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