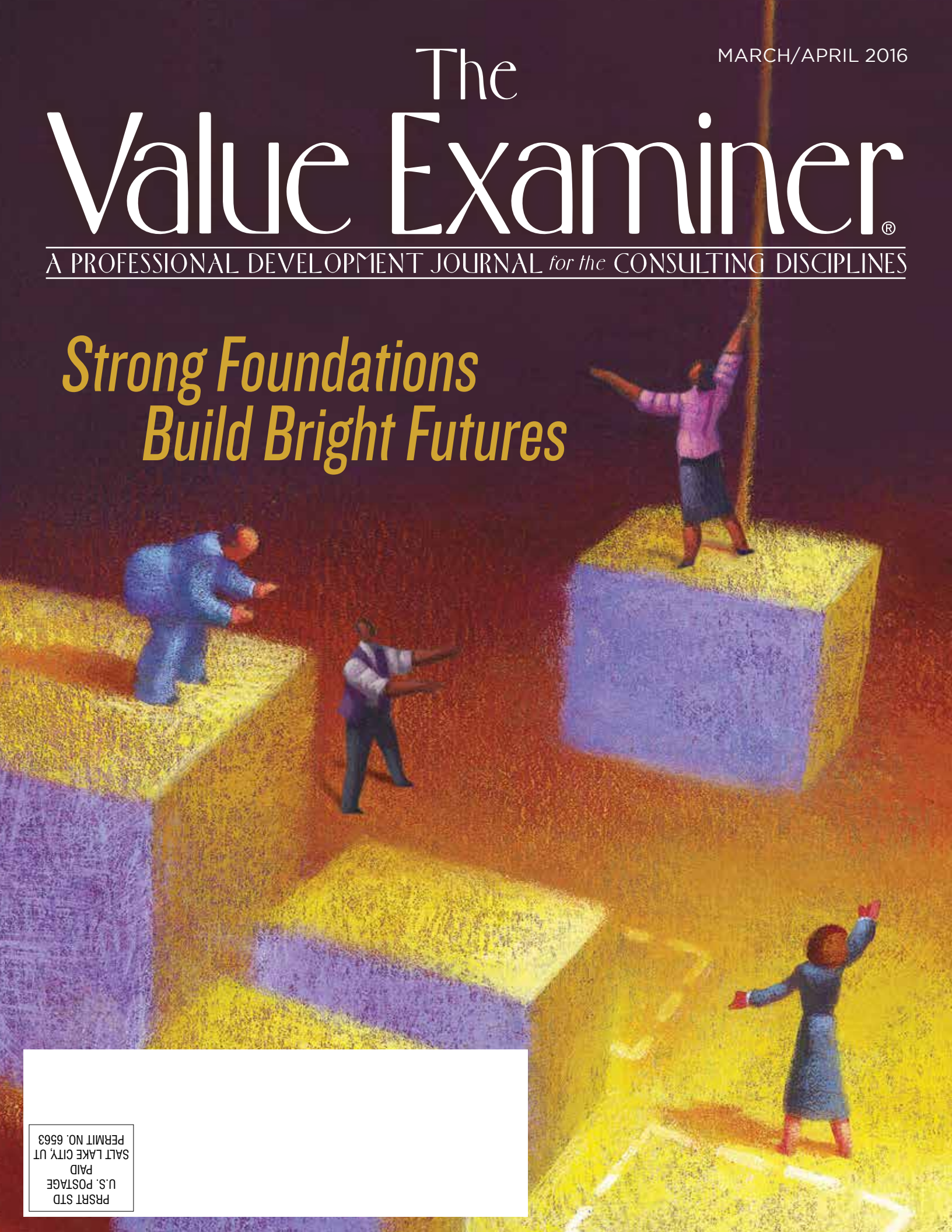
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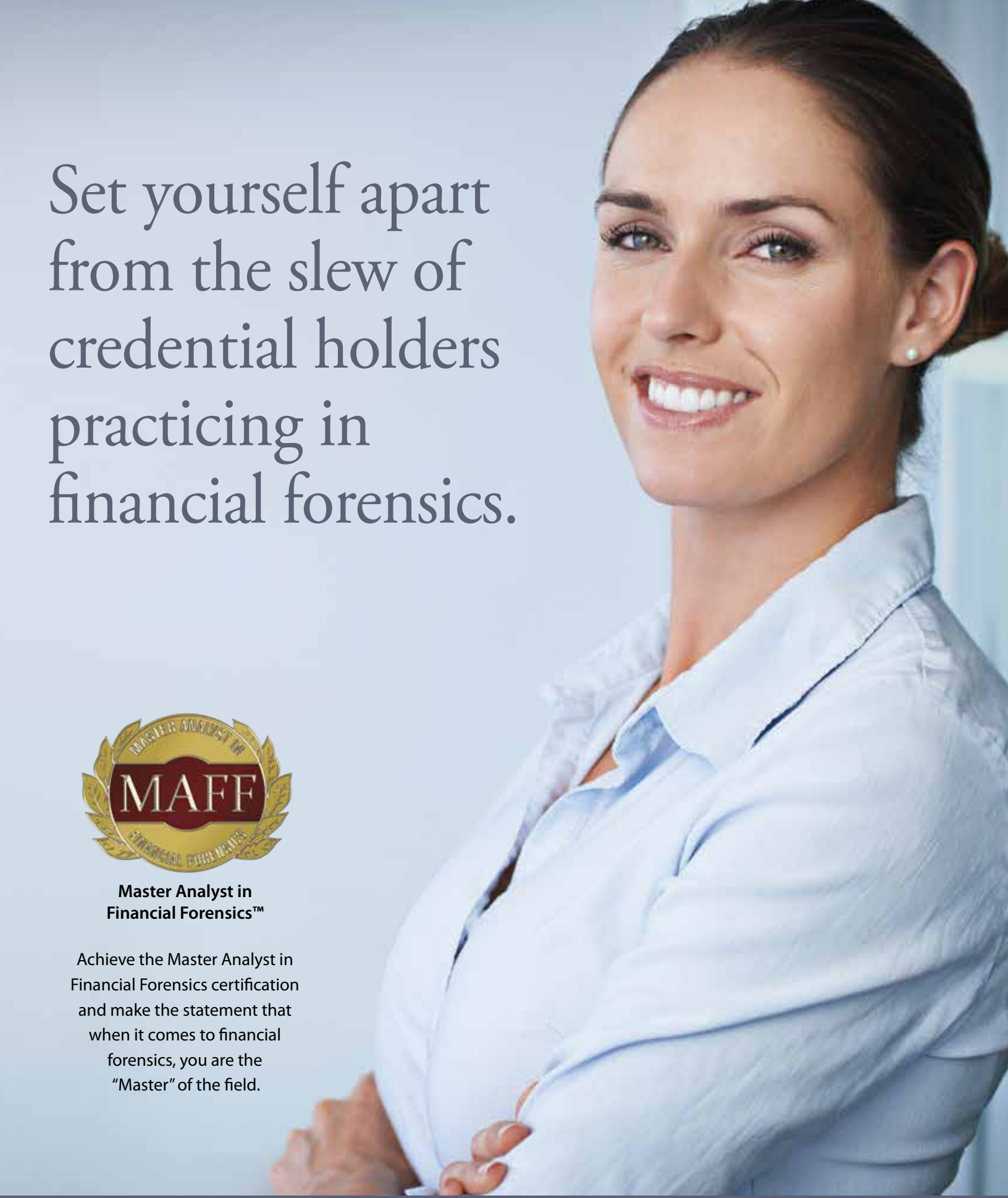
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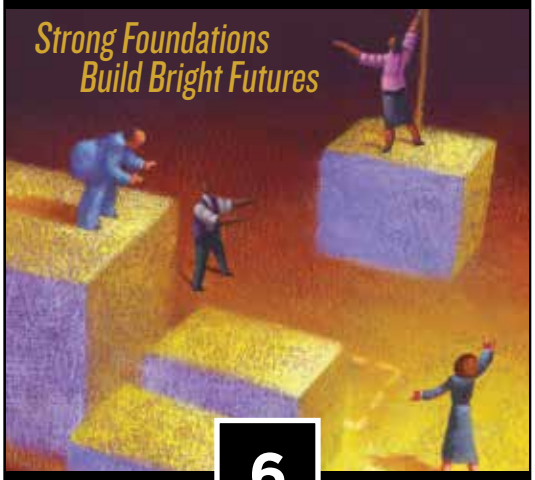
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EQUITY VALUE ENHANCEMENT: A TOOL TO LEVERAGE HUMAN AND FINANCIAL CAPITAL WHILE MANAGING RISK, By Carl L. Sheeler; J. Wiley and Sons, Wiley Finance, Englewood, NJ, December 2015, 368 pages
Reviewed by Michael Gregory, CVA, ASA

Carl Sheeler outlines specific actions to take to improve business practices. He bases this advice on his twenty-five plus years of experience, thousands of appraisals, over 170 expert witness court engagements, and having given over 300 presentations. His goal is to share these experiences to make you even better at what you do.

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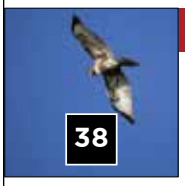


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VALUATION

A New Era for Fair Market Value Physician Compensation

By Mark O. Dietrich, CPA, ABV

With respect to hospital employment of physicians, the last several years have been characterized by a spate of *qui tam* complaints, some of which settled and others, like *Tuomey* and *Halifax*, going to trial with predictably catastrophic results. Relators with detailed knowledge of "insider information" have been at the center of the data gathering for the government, creating a difficult environment for hospital management and compliance officers in the pursuit of hospital-physician integration strategies.

At the heart of most of these cases or complaints, including *Tuomey, Halifax, North Broward,* and *Citizens' Medical*, are losses incurred by the hospitals due to payment of compensation in excess of the net revenues less overhead expenses that the physicians were able to generate from services personally performed or incident to. Like most in the compensation appraisal profession, relators focus on physician compensation benchmarks from the Medical Group Management Association (MGMA) data, as did the government expert in *Tuomey* and *Halifax.* This, then, is a primary source of the losses in physician practices: improper use of MGMA and other survey data in establishing "fair market value."

USE OF SURVEYS

As indicated above, in both appraisal practice and government enforcement, surveys have been employed as a "gold standard" in measuring fair market value for physician compensation, especially the MGMA Physician Compensation and Production Survey, or Report as it is now called.[1] This gold standard stems from the since withdrawn Stark Phase II Safe Harbor in 2007.[2] At the time of the withdrawal, however, regulators stated, "Reference to multiple, objective, independently published salary surveys remains a prudent practice for evaluating fair market value."[3]

As the analysis presented in this article, will demonstrate, this gold standard is based on a series of critically flawed beliefs amongst many regulators and appraisers that:

1. The surveys are a representative sample of the universe of physicians in the United States.
2. All physicians are or will soon be employed by hospitals.
3. There is a national recruiting marketplace for all physicians, whether newly exiting residency or fellowship, or already established in a community.
4. The supply of physicians is uniformly distributed from market to market or, in the alternative, that the supply in a given market or service area is not a relevant consideration.
5. Local payor rates for physician services are not the primary driver of physician compensation.
6. Finally, all physicians should "earn the median" rate per work RVU in the survey(s).

This last factor is at the heart of most losses in physician practices.

1 Something that may be significant in that "survey" conjures up random sampling, which is not the case for the MGMA.
2 72 Federal Register 51012 (September 5, 2007).
3 42 CFR Parts 411 and 424.

ARE SURVEYS REPRESENTATIVE OF ALL PHYSICIANS?

According to the *Association of American Medical Colleges (AAMC) 2013 State Physician Workforce Data Book*, there are more than 700,000 patient care practicing physicians in the country, of whom approximately 684,000 are specified by specialty. The MGMA Compensation Survey[4] contains a sample of only 43,000, depending upon the particular data point being evaluated. The MGMA Survey is not, of course, randomly selected, and thus does not pretend to inform the user about physicians or their practices who do not voluntarily participate. The commonly cited "median" rates every physician must earn or the seventy-fifth percentile rate that should not be exceeded, are simply descriptive statistics about the physicians actually included in the sample. Any attempt to extrapolate those descriptive statistics to the 650,000 or so physicians who were not sampled or eligible to be sampled, would be an exercise in inferential statistics, a completely different undertaking. In short, there is no sound quantitative basis for relying upon surveys as a primary means to measure fair market value compensation.

WILL ALL PHYSICIANS BE EMPLOYED BY HOSPITALS?

The American Medical Association's Policy Research Perspectives: Updated Data on Physician Practice Arrangements: Inching Toward Hospital Ownership released in July of 2015 challenges the commonly held view that most physicians are employed by hospitals or hospital-controlled practices. Whereas something in the vicinity of sixty percent of the datasets in the MGMA survey are hospital or nonprofit employed physicians, the AMA survey finds only 32.8 percent of physicians are hospital employed or employed by practices controlled in part by hospitals, while 56.8 percent work in practices wholly owned by physicians.

There is a significant difference in hospital employment between physicians in single specialty practices and those in multi-specialty practices based on this AMA report. The percentage of physicians employed in single specialty practices who are hospital employed or employed by practices controlled in part by hospitals is only twenty-three percent, while for multi-specialty practices, 44.6 percent of physicians are hospital employed or employed by hospital-controlled practices. 70.5 percent of physicians in single specialty practices worked for practices wholly owned by physicians, while only 38.6 percent of multi-specialty practice physicians worked in practices wholly owned by physicians. At a minimum, survey data is much less relevant to single specialty physicians in private practice considering hospital employment.

IS THERE A NATIONAL MARKETPLACE?

In light of the reliance on national medians in fair market value compensation opinions, one of the more fascinating facts about physician mobility is the general lack thereof. As an example of such reliance on the part of the government, here is an example from the testimony of the government expert in *Halifax*:

> If a physician cannot earn at the median level, he or she can likely move to a community or another environment where median or even above median levels can be earned if warranted by the particular facts and circumstances.[5]

The aforementioned AAMC *2013 State Physician Workforce Data Book* found, among other results:

- Overall, 52.9 percent of the individuals who completed residency training from 2004 through 2013 *are practicing in the state of residency training*. The rate of retention for the *primary care specialties* Family Medicine, Internal Medicine, Pediatrics, and Internal Medicine/Pediatrics *are well above that overall rate*. (*Emphasis added*)[6]
- Family Medicine: 63.3 percent (17,299 of 27,349 graduated residents) practiced in the state where they completed residency training.
- Internal Medicine: 55.5 percent (16,054 of 28,937 graduated residents) practiced in the state where they completed residency training. Significant subsets include 53.3 percent of cardiovascular disease graduated residents, 60.7 percent of geriatric medicine graduated residents, and (only) 41.3 percent of interventional cardiology graduated residents remained in their state of training.[7]

4 http://www.mgma.com/industry-data/all-data-resources/survey-faqs-contents-of-the-reports describes the process; viewed September 21, 2015.

5 *United States of America ex rel. Baklid-Kunz v. Halifax Hospital Medical Center, et al.,* Expert Report, Prepared by: Kathy McNamara, 12/21/2012 ("Halifax Report").

6 Table C4: Physician Retention in State of Residency Training by Last Completed GME Specialty Residents Who Last Completed Training, 2004-2013; https://www.aamc.org/data/420878/tablec4.html (viewed October 17, 2015).

7 *Ibid*

- For physicians who both attended medical school and completed residency in the same state, 66.6 percent nationally (that is two-thirds) of those 236,266 active physicians remained in the same state to practice.

A study in the journal *Health Affairs* sums it up:

> The overall pattern in the data is one of relative stability in the total number of physicians remaining in their practice location if they had completed a residency program at least a year before they moved to that location. *Close to three-quarters of physicians in a post residency practice* ***stayed*** *in their index year practice county over a ten-year interval*. In contrast, nearly three-quarters of physicians *who were in a residency* in the index year *moved during the next ten years*. It has long been held that practice location is heavily influenced by residency location. The scope of the post residency intercounty movement suggests the need for further analysis of that phenomenon to determine whether these moves are to nearby counties or confined to regions. (*Emphasis added*)
>
> *When we examined census data for the general population, we found that physicians in established practice were less likely than the general population to move over a ten-year time period*. (*Emphasis added*)
>
> There is diffusion from the population centers outward, but the regression results suggest that physicians tend to move where they may be taking advantage of greater demand as a result of less competition.[8]

Returning to expert testimony, here is a quote from a report by the same expert, this time in *Tuomey*, which seemingly contradicts the previously quoted testimony in *Halifax*:

> Each of the physicians was asked in their depositions if they had plans, or ever planned, to leave Sumter. In the majority, if not all instances, the physicians clearly indicated they never had plans, or are ever planning to leave Sumter. Most have strong family ties to the community.[9]

That quote is at least consistent with the available data and academic literature, even if reliance on survey medians is not.

WHAT ARE RELEVANT CONSIDERATIONS OF PHYSICIANS?

In fact, the mobility of physicians varies not only by where they attended medical school and trained, but also by the particular specialty in which they train as well as the concentration or density of that specialty in the state in which they train and in states where they might relocate. For example, only 40.4 percent[10] of neurosurgeons practiced in the state where they completed residency training. If one studies the geographic distribution of neurosurgical residency slots, it is easy to see why: they are concentrated in urban areas with tertiary teaching hospitals where there is inadequate demand (or an excess supply) for them post-training. Thus, they need to relocate to obtain work. Maryland, for example, has one neurosurgeon in practice for every 44,580 people (a total of 132),[11] but has seven neurosurgery residency slots.[12] Maine has one neurosurgeon in practice for every 73,844 people (a total of eighteen and forty percent less per person than Maryland),[13] but has zero neurosurgery residency slots.[14] Maine hospitals need to recruit from other states to fill their need for neurosurgeons, while neurosurgeons who train in Maryland are likely to need to relocate to obtain a position. Similar examples abound elsewhere.

WHAT DRIVES PHYSICIAN COMPENSATION?

There is an abundance of data on the dramatic variation in the rates paid per total RVU and/or work RVU in various parts of the country, some of it in the public record and some of it available only in proprietary databases, such as that maintained by large health insurance companies. One excellent example of public data is the (former) Center for Studying Health System Change's Wide Variation in Hospital and Physician Payment Rates

8 Thomas C. Ricketts and Randy Randolph, The Diffusion of Physicians, Health Affairs, 27, no.5 (2008):1409-1415.

9 Rebuttal Report-Amended *U.S. ex rel Michael K. Drakeford, M.D. v. Tuomey Healthcare Systems, Inc.*

10 Table C4: Physician Retention in State of Residency Training by Last Completed GME Specialty Residents Who Last Completed Training, 2004-2013; https://www.aamc.org/data/420878/tablec4.html (viewed October 17, 2015).

11 https://www.aamc.org/data/workforce/reports/profiles/, https://www.aamc.org/download/152138/data/maryland.pdf

12 2015 NRMP Main Residency Match®: Match Rates by Specialty and State.

13 https://www.aamc.org/download/152132/data/maine.pdf

14 2015 NRMP Main Residency Match®: Match Rates by Specialty and State.

Evidence of Provider Market Power[15] that looked at payment rates as a percentage of Medicare at the seventy-fifth percentile in such diverse markets as Cleveland, Los Angeles, and rural Wisconsin and found dramatic differences.

The Resource-Based Relative Value Scale (RBRVS) system used by Medicare to establish rates or conversion factors per RVU includes Geographic Practice Cost Index (GPCI) adjusters intended to account for local market differences in practice expenses, malpractice insurance costs, and physician compensation. Compare, for example, the GPCI for practice expenses in San Francisco (1.26) to that in Indianapolis (.921); it is thirty-seven percent greater. The cost of living index in San Francisco is 159.1,[16] while in Indianapolis it is 89.1.[17] The median home price in San Francisco is $1.0 million[18] while in Indianapolis it is $132,800.[19] Suffice it to say that these factors have a dramatic influence on payor rates and physician incomes in a given locality.

SHOULD ALL PHYSICIANS EARN THE MEDIAN RATE?

Of course, given that the "median" is defined as the midpoint in a sample, if everyone made at least the median, it would no longer be the median, so this sets up a logical fallacy. That said, it should be obvious from the start that a hospital employing a physician on the basis of a national median compensation rate per work relative value unit (RVU) that exceeds the rate being paid in the local service area by payors is going to lose money. However, the problem is even more severe even more severe.

Standard appraisal practice is to use work RVUs as a denominator for determining such benchmarks as compensation and collections for professional services. That is done even though payors pay a rate or fee for the total RVUs (work, practice expense, and malpractice), not just work RVUs. For example, in the 2014 MGMA survey, the median rate of professional collections per **total** RVU for Internal Medicine physicians was $37.09, while the median rate of professional collections per **work** RVU was $80.42. The spread of some fifty-three dollars is because collections represent payments for all types or total RVUs and work RVUs are only a subset of what is being paid for. Median compensation per work RVU in that survey was $50.74 (sixty-three percent of $80.42), something that should strike someone familiar with Internal Medicine practices as a very high ratio of compensation to collections, as it leaves only thirty-seven percent of collections to pay practice expenses and malpractice insurance.

This standard approach is then compounded by yet another peculiar aspect of survey data: "compensation" per work RVU is defined to include only direct compensation (e.g., W-2 salary) while work RVUs in the RBRVS are defined to include both physician salary *and* benefits. Thus, standard appraisal practice is to then add retirement and other benefits on top of the direct compensation. Returning to our example, if physician benefits were twenty percent of direct physician compensation, or $10.15 ($50.74 times twenty percent), this would leave only $19.53 to pay practice expenses and malpractice insurance, an overhead rate of only twenty-four percent. Given that the normal range of overhead in an Internal Medicine practice would be fifty-five percent to sixty percent,[20] a loss—a large loss per dollar of collected revenue—that will invariably result.

WHERE DO WE GO FROM HERE?

Thus far, the focus of *qui tam* complaints has been on exceeding the MGMA survey data, e.g., the ninetieth percentile as if that were some kind of mythical barrier, and the failure to meet a commercial reasonableness standard where physician practices lose money. The Stark regulations for both fair market value and commercial reasonableness require that the volume or value of referrals not be taken into account. There can be differences in applying the two standards such that a particular price or compensation rate may be fair market value but not commercially reasonable. In light of the fact, however, that the common use of compensation per work RVU in compensation appraisal will almost certainly generate a loss that will need to be funded from other hospital revenue sources, it seems unlikely that the volume or value of referrals is not implicated in survey data, thus precluding it's use as a sole or primary method of determining fair market value.

15 Wide Variation in Hospital and Physician Payment Rates Evidence of Provider Market Power HSC Research Brief No. 16 November 2010 Paul B. Ginsburg.

16 http://www.city-data.com/city/San-Francisco-California.html (March 2013 data viewed October 17, 2015).

17 http://www.city-data.com/city/Indianapolis-Indiana.html (March 2013 data viewed October 17, 2015).

18 http://www.sfgate.com/business/networth/article/1-million-city-S-F-median-home-price-hits-7-5626591.php (October 17, 2015).

19 http://www.zillow.com/indianapolis-metro-in_r394705/home-values/ (October 17, 2015).

20 See, for example, the National Society of Certified Healthcare Business Consultants' Healthcare Professional Practices Income and Expense Averages 2014 Report Based on 2013 Data.

In addition, something in the vicinity of sixty percent of the MGMA sample data is now from hospital or hospital controlled physician practices, implicating the Stark prohibition against using market data from parties in a position to refer.

Thoughtful use of survey data should, in fact, be part of the overall analysis of fair market value in conjunction with a number of other factors heretofore not commonly employed. These other factors include:

1. Supply and demand of a given specialty in the market area as evidenced by individual state workforce analysis and such things as community needs assessments.
2. Local market payor rates for physician services and notably, the rates paid for physicians working at competing institutions or practices, where obtainable.[21]
3. The GPCI and Cost of Living Index for a given market area; in using national medians from surveys, it may be appropriate to adjust benchmark rates for cost of living differences assuming for analysis purposes that the national median has a GPCI or COLI of 1.00.
4. A move away from the use of work RVUs in the denominator and towards the use of total RVUs, consistent with the RBRVS. Reiterating, the present appraisal standard of using direct compensation per work RVU will almost assure that the practice loses money.
5. Comparing average payor rates per **practice expense RVU** to the expected practice expense (excluding physician compensation) costs per **practice expense RVU** to be incurred by the employing institution. For institutions with poor payor mixes, this is especially important.
6. For physicians already established in the community who the hospital seeks to employ, obtaining and understanding data on their payor rates per RVU[22] and historical earnings, including sourcing those earnings between work RVUs for services personally performed, earnings linked to the technical component of ancillary services, earnings linked to the use of midlevel providers and other earnings, including high productivity resulting in a profit on practice expense RVUs, or payor incentive distributions not linked to RVUs.

CONCLUSION

It is critical to identify the likelihood of a loss at the outset of the employment relationship and to contemporaneously document the rationale for incurring the loss in order to substantiate that something other than proscribed referrals was the motivation. There are likely hundreds of *qui tam* Relator complaints still under seal, and recent successes are likely to encourage more such complaints. In order to end one source of these complaints, it is incumbent upon the producers and users of fair market value compensation reports to update their methodologies consistent with available data. One would also hope that regulators would consider their recommended reliance on surveys as a "prudent practice" when evaluating any allegation of "knowingly presenting" a false claim under the False Claims Act.

Survey usage and the resultant high physician compensation also have social policy implications. Safety net institutions and those with less negotiating clout than their wealthier competitors often cannot match employment offers, and therefore lose physicians and, of course, the revenue they generate, leading to a downward financial spiral. With this in mind, however, it should not be commercially unreasonable to match the physician compensation paid in the same market by a competitor with better payor rates or payor mix, even if it results in losses. VE



Mark O. Dietrich, CPA, ABV is a nationally recognized valuation expert and speaker on the healthcare industry with more than 400 valuation engagements. He is editor and contributing author to the Business Valuation Resources/ American Health Lawyers Assn. Guide to Healthcare Finance and Valuation, 4th Edition published in April 2016 as well as co-editor or contributor to numerous other books on the healthcare industry. E-mail: dietrich@cpa.net

21 As price transparency takes hold, this will be an easier undertaking.

22 Subject, of course, to legal advice on any antitrust restrictions. A neutral can undertake such work subject to limited reporting to the parties as to the findings.

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Conference Presentations (550+ presentations)	✓	✓	✓	✓	✓
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VALUATION

Valuation Insights in the Dental Industry

By Maria G. Melone, CPA, CVA

If you have a client who is considering either the purchase or sale of a dental practice, he or she might be grappling with pressing, complex questions. For example, a buyer or seller might wonder: *What is the value of a dental practice? Is it an average of the last three years' collections? Is it 1.5 times the total net earnings? Or, is it determined by one of the other commonly used subjective methods employed by most dental brokers in the country?*

The fact is, none of these methods is based on accepted business valuation principles. To better position your practice for success, remind your client to start with the premise that the fair market value of any business is the agreed upon value between a seller and a knowledgeable and willing buyer.

WHO BUYERS AND SELLERS RELY ON FOR VALUATION INSIGHTS

Just how knowledgeable are buyers and sellers today? Based on my experience, most sellers do not know the value of their dental practices, and as a result, rely on a broker to provide an opinion of value. In many cases, buyers accept the values established by the brokers simply because they are able to obtain the financing to complete the transaction. The fact that a practice can be financed is not a qualifier of its value, especially in today's competitive lending environment. Almost every bank across the country today is trying to put money to work in the dental industry—and who can blame them when default rates are below one percent? Over the last several years, lending rates have hovered around five percent. This begs the question: What are brokers going to do when rates eventually rise?

THE THREE PILLARS OF BUSINESS VALUATION

The value of any business is largely based on the riskiness of the investment and the return on investment inuring to the benefit of the buyer. In business valuation, there are three main approaches to value: Asset, Income, and Market.

1. In the Asset Approach, the valuator calculates the value of each individual tangible asset and then factors in the value of the intangible assets, less net liabilities, to arrive at the total value. The Asset Approach is best used for companies that have a significant amount of value in their tangible assets—such as a real estate trust—or conversely, companies that have inferior financial results. When you consider the components of value of a dental practice, the most significant value comes from the intangible value of the practice, or the future economic benefit to the owner, not the tangible assets.
2. In the Income Approach, the valuator calculates the value of both the tangible and intangible assets collectively by applying a rate of return to an earnings stream. The Income Approach is best used for operating companies whose value lies in the ability to generate an earnings stream in the future.
3. The Market Approach is quite complex, but to put it simply, takes

attributes of completed transactions and applies those to the subject company. The greatest challenge with this approach is finding transactional data for truly comparable companies.

THE MOST RELEVANT APPROACH TO BUYING/SELLING A DENTAL PRACTICE

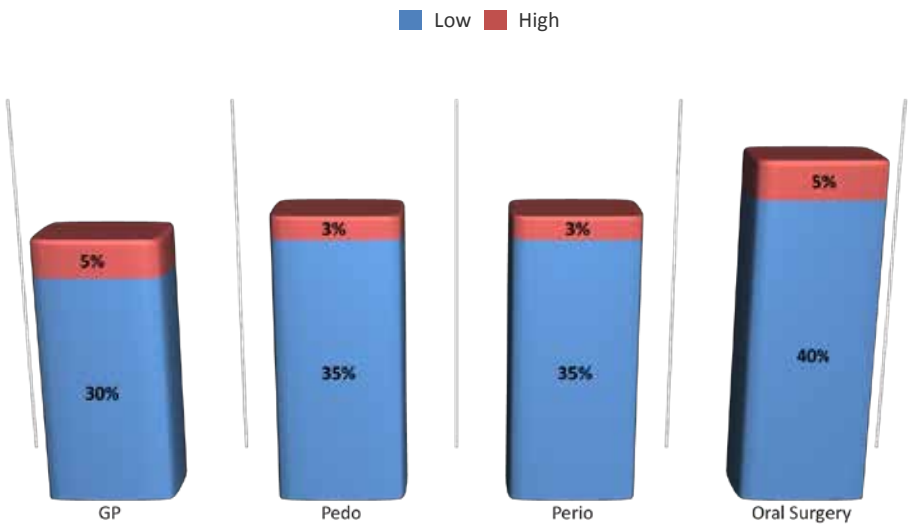
As it relates to dental practices, the Income Approach is most relevant and effective. For a majority of dental practices, the significant value lies in future earning potential and the transfer of the patient base (an intangible asset) from the seller to the buyer. In my opinion, the Income Approach is the best course of action, however, the value you derive should be consistent under any approach, provided you apply the approach properly.

When valuing a dental practice, the income stream I prefer to work with is the after-tax cash flow of the business, which gives consideration for on-going capital needs and debt service. In order to arrive at the cash flow of most privately owned businesses, there are a number of normalization adjustments required to properly reflect the cash flow to any owner and not just the current owner. These adjustments include such things as automobile, supply, and telephone expenses which are not directly tied to the operation of the business. However, the most significant adjustment in a dental practice is for owner compensation.

Most owner-dentists do not distinguish income earned from providing patient care, managing the business, or profit for being the owner. Doctor compensation does vary based on region and by specialty. Based on my fifteen plus years in the dental industry, ten of which were working for one of the largest dental support organizations in the country, and having had reviewed over 1,000 dental practices, a general practitioner should be paid between thirty to thirty-five percent of their personal collections based on patients they have treated; on top of which you would also want to include the cost of payroll taxes and standard benefit package.

A rate of eleven percent of wages is appropriate to account for the payroll taxes and standard benefit package for a dentist. Many solo practitioners hire office managers to manage the day-to-day operations, including human resource issues, and bookkeepers to pay their bills, but if this is not the case, you may need to consider adding some additional compensation for the management of the business.

TABLE 1: DOCTOR COMPENSATION BY SPECIALTY



The nature of orthodontic treatment over time and how it is paid for, which can vary, necessitates compensation be calculated under a method other than a percent of collections. A daily rate best accounts for the clinical effort expended by the orthodontist and can range from $700–1,800 per day. The two factors impacting the range the most are the experience of the doctor and the number of patients seen per day.

One other, often significant adjustment is rent expense. For tax-planning purposes, when the owner of the practice and the owner of the real estate are the same, it is not uncommon for the dental practice to pay something over market rates in rent expense. In order to properly value the business, an adjustment to fair market value rates is needed. Generally, there is some publicly available data to determine the appropriate rate, but you may also consider using a company such as Carr Healthcare Realty (www.carrhr.com) to give you a detailed assessment of the fair market value rates in any given area given their extensive

expertise and knowledge. These non-recurring, normalizing or discretionary expense adjustments results in the determination of the true cash flow of the business to any owner, not the current owner.

HOW THE DENTAL INDUSTRY VIEWS THE VALUE OF A PRACTICE

Many people in the dental industry refer to the value of a practice in terms of its percentage of last year's collections and this range, for a solo GP practice, is sixty to seventy-five percent. It is fairly easy to obtain data on actual practice sales and note the actual price paid to last year's collections, but when applying this to your subject company, you lose visibility on most of the factors that directly contribute to the value of the particular practice in question. It is also now common to refer to a practice's value as a multiple of EBITDA (Earnings Before Interest Taxes Depreciation and Amortization) as a result of the influx of private equity money in the industry.

You may hear of multiples from three to fourteen times EBITDA, which is quite a range, but there is also now significant interest from non-dentists interested in investing in the dental industry which is leading to the escalation of these multiples. A solo practitioner's practice will likely receive a multiple of three to four times; a multi-doctor practice will receive four to five times; and a multi-location, multi-doctor practice, five to six times.

CONCLUSION

There are many factors that influence where the multiple lands. Some of the most significant include, in no particular order, location, trained staff, stable or growing revenue stream, type of revenue e.g., FFS, PPO, DHMO, MCD, condition of the facility, mix of services, patient demographics, and profitability. In order to achieve a multiple over six times, the most critical factors are the presence of a management team, documented policies and procedures, strong historic growth, and a pipeline for future growth.

As stated previously, I do not solely rely on the Market Method due to the lack of detailed transaction data. I am however in the process of working with the members of the Academy of Dental CPAs across the country to develop our own database of actual transaction data with the necessary specificity of the attributes I consider to most directly impact the value of a dental practice. Once this database is compiled, I will have the ability to more confidently look to and rely on the Market Approach for determining value, or at a minimum, use this as a supporting secondary method. VE



Maria G. Melone, CPA, CVA, began her accounting career at KPMG. She then spent ten years working for one of the largest dental support organizations, handling all aspects of the buy-side of dental transactions. She has helped facilitate hundreds of transactions and has valued even more. She is a founder of MORR Dental Solutions, LLC and dentaldealmate.com. E-mail: mmelone@morrds.com.



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VALUATION

Case Study (Part I): Applying And Assessing The Capitalization Rate

By Pasquale Rafanelli, CPA, ABV, CVA, CBA, ASA, CFE

When performing a valuation, there are three approaches all appraisers are required to look at:

1. Asset Approach
2. Market Approach
3. Income Approach

Within these three basic approaches are multiple methods. One of the methods that valuation experts often employ is the Income Approach, where the earnings of the business are divided by a capitalization rate (cap rate) to arrive at the value of the business. The cap rate is one of the most crucial factors in an appraisal, and if incorrectly calculated, could have a major impact on the concluded value of a business. The lower the cap rate the higher the value; conversely the higher the cap rate the lower the value.

It is essential to assess the reasonableness of the cap rate, regardless of the purpose of the valuation report. This case study will explain the different methods a valuation expert could utilize in determining the discount rate, as well as, the variety of factors that enter into its determination.

WHAT IS THE CAPITALIZATION RATE?

The definition of cap rate as provided by the international glossary of business valuation terms is "any divisor (usually expressed as a percentage) used to convert anticipated economic benefits of a single period into value." In its simplest form, the cap rate is the discount rate (cost of capital) for the subject company, less the expected long-term sustainable growth rate in the cash flow from the subject company. The discount rate according to the international glossary of business valuation terms "is a rate of return used to convert a future monetary sum into present value." Therefore, in order to have any meaningful understanding of the cap rate, it is imperative we break down the components of the discount rate.

The two most widely used methods of estimating the discount rate are the build-method, and the capital asset pricing model (CAPM). Although not as popular for nonpublic companies, the valuation expert can use the weighted average cost of capital in arriving at the discount rate. The build-up method can be calculated two different ways, either using the CRSP Deciles Size Premia or the Risk Premium Report. The build-up methods and CAPM are considered cost of equity methods to determine the discount rate while, the WACC is a hybrid of both the equity and the debt components in arriving at the discount rate.

In this article, we will discuss the formulas for each method and how to properly apply the methods in determine the discount rate in order to arrive at the appropriate cap rate.

TABLE 1: THE BUILD UP METHODS AND CALCULATIONS

Method	Formula
Build-Up One (CRSP Deciles Size Premia)	Ke = Rf + RPm + RPi + RPs+ RPc
Build-Up Two (Risk Premium Report)	Ke = Rf + RPm+s + RPc + ERP Adjustment
CAPM	Ke = Rf + ß X (RPm) + RPs + RPc
WACC	WACC = (Ke X We) + (Kd(pt) [1 - T] X Wd)

K_e = Cost of equity
R_f = Risk-free rate
RP_m = Equity risk premium (ERP)
RP_i = Industry risk premium
RP_s = Size premium
RP_c = Company-specific risk premium
B = Beta
RP_{m+s} = Equity (market) risk premium plus size premium combined
ERP Adjustment = an adjusted to account for the difference between the forward looking ERP that the valuation expert has selected and the historical ERP.
W_e = Weight of common equity capital in the capital structure
$K_{d(pt)}$ = Cost of debt capital (pre-tax)
T = Income tax
Wd = Weight of debt capital in the capital structure

From this point on, we will discuss the factors above, in detail, in order to arrive at the discount rate for the cost of equity using either the build-up method using CRSP Deciles Size Premium (Build-Up One); or the build-up method using Risk Premium Report (Build-Up Two) in this case study; and the capital asset pricing model (CAPM). Once we have a through understanding of how to determine the discount rate using the cost of equity, we will then discuss the discount rate using the WACC.

INTRODUCTION TO THE CASE

Griffin Semiconductor, Inc., (Griffin) is a distributor of electronic components in the high reliability military and aerospace markets. Griffin operates primarily under SIC code 5065, defined as "establishments primarily engaged in the wholesale distribution of electronic parts and electronic communications equipment, not elsewhere classified." According to the U.S. Census Bureau, SIC 5065 best corresponds to NAICS 423690, which is defined as "establishments primarily engaged in the merchant wholesale distribution of electronic parts and equipment." Table 2 includes some key financial information of Griffin for the year ended December 31, 2014.

TABLE 2: FINANCIAL INFORMATION FOR GRIFFIN SEMICONDUCTOR, INC

Financial Metric	2014
Revenues	$68,473,600
Gross Profit	$19,335,200
EBITDA	$9,742,500
Net Income	$5,684,200
5-Year Average EBITDA	$7,205,200
5-Year Average Net Income	$4,130,377
Total Assets	$47,314,100
Total Long-Term Debt	$2,528,300
Total Liabilities	$16,139,600
Book Value of Equity	$31,174,500
Number of Employees	50

BUILD-UP RISK–FREE RATE – R_f

The risk free rate is the starting point of the three methods used to estimate the discount rate of the cost of equity. The risk-free rate is the return available on a security that the market generally regards as free of the risk of default. Many valuation experts, as a starting point, rely on the twenty-year constant maturity U.S. government bond as a proxy for the risk-free rate. The yield to maturity on twenty-year U.S. Treasury obligations is used as the risk-free rate because:

1. It most closely matches the often-assumed perpetual lifetime horizon of an equity investment.

2. The longest-term yields to maturity fluctuate considerably less than short-term rates and thus are less likely to introduce unwarranted short-term distortions into the actual cost of capital.

3. It matches the longest-term bond over which other components of investment risk are measured.[1]

During periods of increased inflation, the risk-free rate increases, thus increasing the discount rate arrived at using the cost of equity methods. Similarly, during periods of decreased inflation, the risk free-rate decreases, thus decreasing the discount rate arrived at using the cost of equity methods. As a result, valuation analysts may want to consider normalizing the risk-free rate, and taking the average over the last ten as a simple and appropriate way of normalizing the risk-free rate. As of the valuation date used throughout this article, December 31, 2014, the risk-free rate was 2.47 percent.[2] The ten-year average (12/31/2004 through 12/31/2014) was 3.94 percent. According to the *2015 Duff and Phelps Valuation Handbook - Guide to Cost of Capital,*[3] they recommend using a normalized risk-free rate of four percent at the valuation date 12/31/2014.

Thus, for purposes of the example in this article, I have chosen to use four percent, which is equivalent to both the ten-year average and the recommended rate in the Valuation Handbook.

EQUITY RISK PREMIUM - RP_m

The equity risk premium is the extra return that investors demand to be compensated for when investing in a diversified portfolio of large common stocks rather than investing in risk-free securities. The risk-free rate discussed above can be viewed as investing in U.S. Treasury Bonds. For example, an individual puts $100 into a bond and is guaranteed the $100 plus interest at the maturity date. Using this example, why would an investor want to put their money in a vehicle that has no guarantee, unless they are getting a payback that meets their risk? This is where the equity risk premium comes in, and attempts to account for and compensate the investor for the increased risk they would see when investing in the market.

There is no single universally accepted methodology for estimating the ERP. Prior to Duff and Phelps acquiring Ibbotson from Morningstar, there were two generally accepted equity risk premiums for the valuation expert to select from: the long-horizon expected equity risk premium (historical), and the long-horizon expected equity risk premium (supply-side). Since the merger in 2013, there has been a third option added to the Duff & Phelps recommended equity risk premium (conditional). and is important to note that the ERP can be thought of in terms of *unconditiona*l ERP[4] or *conditional* ERP.[5]

Unconditional

Although ERP is a forward-looking concept, there are some valuation analysts who use historical data to estimate the ERP under the assumption the historical data is a valid proxy for current investor expectations, as the past provides a reasonable indicator of how the market will behave in the future. The major flaw in this concept, is the ERP would have been added to the risk-free rate at the valuation date regardless of the risk-free rate during that year and regardless of any changes in risk in the economy.

The historical ERP and the supply-side ERP are the same equation with slightly different inputs. The historical ERP is calculated as the large company stock total return minus long-term government bond income returns. The supply-side ERP is calculated as the historical equity risk premium minus price-to-earnings ratio calculated using the three-year average earnings. The difference lies within the equity returns whereby the supply-side ERP only includes the returns attributable to economic growth (i.e., inflation) and company earnings as it removes the price-to-earnings ratio from the calculation. The ERP in general, assumes the historical data, which covers the period from 1926 to present, included within the calculation is representative of the future. The supply-side ERP was created to remove the unsustainable growth that we sometimes see in the industry as most companies would be unable to catch up to those inflated prices. It is worth nothing when the supply-side ERP is lower than the historical ERP, it implies investors expect high growth in future earnings. This would mean that in periods of economic down turn when investors foresee a future of declining earnings, it is not unrealistic to see a supply-side ERP that is higher than the historical ERP.

1 Pratt, Shannon P., *Cost of Capital, Applications and Examples*, John Wiley & Sons, Inc., Fifth edition, 2014, page 60.

2 Federal Reserve Statistical Release H-15, accessed at www.federalreserve.gov/releases/h15/data.htm#top.

3 Unless otherwise noted, the Valuation Handbook referred to throughout this report is the *2015 Duff and Phelps Valuation Handbook – Guide to Cost of Capital.*

4 The long term average through the business cycle.

5 Based on current levels of the stock market and economy relative to the long-term average.

It is important to note that the historical ERP and the supply ERP found in the Duff and Phelps and prior Ibbotson Valuation Handbooks are based on the unconditional ERP.

Conditional

Research has shown the ERP varies through business cycles, which is where a conditional ERP comes in handy since it reflects current market conditions. Those market conditions reflect both the risk of investment and the collective risk of aversion as viewed through the eyes of investors. In English, this means the ERP should be greater when uncertainty is higher and smaller when uncertainty is lower. This concept became very obvious in the fourth quarter of 2008 when the financial crisis hit. For example, the risk-free rate on December 31, 2007 was 4.5 percent and the equity risk premium as reported in Ibbotson's valuation year book was 7.1 percent. Fast-forward one year to December 31, 2008. On that date, the risk-free rate was 3.05 percent and the equity risk premium reported in Ibbotson's valuation year book was 6.5 percent. Just looking at these two factors shows the cost of equity on December 31, 2007 was 11.6 percent, and at December 31, 2008 it was 9.55 percent. On December 31, 2008, the economy was weaker and the uncertainty was stronger than on December 31, 2007, but the risk, according to the unconditional data, was lower, which would have produced a higher concluded value, which does not make logical sense.

This is where the conditional ERP comes in, as the closer the economy is to a recession, the higher the conditional ERP is, thereby accounting for the greater risk. Conversely, the closer the economy is to its peak performance, the lower the conditional ERP is, thereby accounting for the lower level of risk.

It is important to note that the Duff and Phelps recommended ERP found in the Valuation Handbook is based on the conditional ERP.

Below are the ERPs, both unconditional and conditional, as of the valuation date selected in our analysis of December 31, 2014:

TABLE 3: 2015 DUFF AND PHELPS VALUATION HANDBOOK – GUIDE TO COST OF CAPITAL

Historical long-term ERP - unconditional	7.00%
Supply-side long-term ERP - unconditional	6.21%
Duff & Phelps recommended ERP - conditional	5.00%

It is important for all valuation experts to remember that there is no correct ERP method to use when determining the appropriate ERP for use in the discount rate. What is important, is for the valuation expert to be familiar with all methods regarding ERP, to select the one that is most appropriate, and to apply it correctly and consistently from one valuation engagement to the next.

The Equity Risk Premium is directly used in the Build-Up One and the CAPM, and is indirectly used in the Build-Up Two through the ERP adjustment. Thus, for purposes of the example in this article, I have chosen to use the Duff and Phelps Conditional equity risk premium of five percent, as reported in Appendix 3 of the Valuation Handbook.

As mentioned above, the equity risk premium is not separately stated in the Build-Up Two method. Instead, it is combined with the size premium and is shown as one combined number. We will discuss this method in more detail in a later section, equity risk premium plus size premium combined RP_{m+s}.

SIZE PREMIUM - RP_s

The size of a company is an important risk element to consider when developing a discount rate, simply because it is based on expected returns for large company stock. As a result, the size premium is an important risk element to consider as size tends to be a predictor of equity returns. Simply put, as size decreases risk tends to increase, and vice versa. The size premium is calculated as the realized return less the estimated return.

The difference between the historical returns on large public company stocks and the returns of small public company stocks represents the size risk premium; that is, the incremental return demanded by investors in order to accept the higher risk inherent in an investment in equity securities rather than risk-free securities. Several studies[6] have provided strong evidence that the degree of risk, and the corresponding cost of capital, increase as the size of the underlying company decreases. This Small Stock Premium phenomenon is especially noticeable for the smallest ten percent (the tenth decile) of the companies studied.

Over longer periods, the small-cap stock appears to constantly outperform the large-cap stock, whereas over the shorter term, small-cap stocks' behavior can be erratic compared to large-cap stocks. As the holding period increases, the tendency of small-cap stocks to outperform large-cap stocks increases. Thus, analyzing small-cap stocks performance relative to large-cap stock can be instructive in revealing long-term trends. This can be shown in Table 4.

TABLE 4: SMALL-CAP STOCKS PERFORMANCE V. LARGE-CAP STOCKS PERFORMANCE

Holding Period	1-year	5-years	10-years	20-years	30-years
Small-cap companies outperformance (%)	53.8%	58.7%	70.9%	80.8%	90.4%
Large-cap companies outperformance (%)	46.2%	41.3%	29.1%	19.2%	9.6%

The CRSP database was created in the early 1960's and represents market value[7] and return data[8] going back to 1926. The CRSP data categorizes the public stock marketplace into ten deciles, based on the market capitalization of the companies in the market. The largest-cap companies were categorized in decile one and the smallest-cap companies were categorized in in decile ten. The results clearly show, as the size of the companies in the decile decreases, the small stock premium increases.

The CRSP data further breaks down the tenth decile into four parts, known as 10w, 10x, 10y, and 10z. Recent studies[9] have performed a closer examination of the companies that comprise the tenth decile, as well as the smaller subgroups. The smallest and largest market capitalization is described in the Valuation Handbook.

These studies question whether the companies that populate the tenth decile exhibit higher returns because their risk results from their small size (as measured by market capitalization), or whether they exhibit other characteristics of risk to which the market reacts by driving down their price and thus their market capitalization (therefore making them small as determined by their market capitalization).

The studies separated the companies into two groups. The first group consisted of companies that exhibited what the study referred to as "high financial risk" and the second group consisted of companies that exhibited what the study referred to as "distressed." These companies, among other things:

6 See *2015 Duff and Phelps Valuation Handbook – Guide to Cost of Capital*, chapter 4.
7 Stock price times the number of shares
8 Dividends and change in stock price.
9 *Duff and Phelps, LLC Risk Premium Report 2015*, published by Duff and Phelps. LLC, Chicago, Illinois, 2015.

- Lacked five years of trading history
- Had revenues below one million dollars in any of the five preceding years
- Had negative five-year average EBITDA
- Were in bankruptcy or liquidation
- Had debt-to-total capital of more than eighty percent
- Had negative book value of equity for any of the preceding five years

These high-financial risk companies and distressed companies made up about twenty-five percent of the data set in recent years, clearly introducing an upward bias to the risk profile of the data set. The results of the study showed a marked differential between the historical average return for high financial risk companies and distressed companies and the others. The disparity between the rates of return for high financial risk companies and distressed companies, and those that are small but otherwise reasonably healthy, calls into question the use of the tenth decile, or any of the smaller subgroup in the build-up method or CAPM, as a proxy for a small size premium.

The risk premium report studies use a different methodology from the CRSP deciles size premium studies. One of the most noticeable differences, is the CRSP studies measure size solely by market value of equity, whereas, Duff & Phelps studies measure size by eight measures. The other noticeable difference is that Duff & Phelps adds a regression technique to smooth its size premia where the CRSP data uses raw premia. The risk premium report is calculated from 1963 to the present and the studies screen out speculative start-ups, distressed companies, and other high-financial-risk companies. The eight measures of size used by Duff and Phelps are:

1. Market capitalization
2. Book value of equity
3. Five-year average net income
4. Market value of invested capital
5. Total assets
6. Five-year average EBITDA
7. Sales
8. Number of employees

There are several reasons why Duff and Phelps believes in using alternative measures of size[10]:

1. Financial literature indicates that a bias may be introduced when ranking companies by market value, because a company's market capitalization may be affected by characteristics of the company other than size. In other words, some companies might be small because they are risky rather than risky because they are small.
2. Market capitalization may be an imperfect measure of the risk of a company's operations.
3. Using alternative measures of size may have the practical benefit of removing the need to first make a guesstimate of size in order to know which portfolio's premium to use.
4. When doing analysis of any kind, it is prudent to approach things from multiple directions, if at all possible.

One thing is clear, is for the eight factors in the risk premium report, the average annual return of the portfolios tend to increase as size decreases.

Thus, for purposes of the example in this article, I have chosen to use the micro-cap 9-10 as shown in Appendix 3 of the Valuation Handbook of 3.74 percent, for use in the Build-Up One method and the CAPM.

As mentioned above, the size premium is not separately stated in the Build-Up Two method. Instead it is combined with the equity risk premium and is shown as one combined number. We will discuss this method in more detail in a later section on the combined equity risk premium plus size premium $RP_{m+s.}$

COMPANY SPECIFIC PREMIUM - RP_c

Quantifying the company-specific risk is one of the most controversial and elusive areas in the discount rate. Many courts do not find the company-specific risk premium to be reliable and therefore, valuation experts need to be cautious when using and avoid using unsubstantiated premiums. "Much of the precedent-setting opinions regarding [the company specific-risk premium] derive from opinions of the Delaware Chancery Court. Given that court's profound understanding of Delaware corporate law and corporate governance, it is widely seen as the nation's preeminent business court. This is one of the main reasons why many corporations decide to incorporate in Delaware. The Delaware Court of Chancery has historically rejected the use of [company-specific risk premiums] in the discount rate."[11] Further, "to judges, the company-specific risk premium often seems like the device experts employ to bring

10 Pratt, Shannon P., *Cost of Capital, Applications and Examples*, John Wiley & Sons, Inc., Fifth edition, 2014, page 317.

11 Pratt, Shannon P., *Cost of Capital, Applications and Examples*, John Wiley & Sons, Inc., Fifth edition, 2014, page 398-399.

their final results into line with their clients' objectives, when other valuation inputs fail to do the trick."[12]

Unlike the equity risk premium and the small stock premium that are based on studies of thousands of companies in the marketplace, there is limited research on quantifying the risk premiums for specific-company risk. The subject company's unique risk characteristics may be greater or less than the typical risk characteristics of the broad stock market represented by companies included in the studies, and therefore, may not be captured in the build-up method as applied up to this point. Further adjustment to the cost of capital may be necessary to arrive at a discount rate specific to the subject company. Some factors specific to a particular company that affect risk could include, but are not limited to:

- Size
- Profitability
- Financial risk
- Characteristics related to the business environment
- Geographic diversity
- Product diversity
- Employee turnover and training
- Fixed versus variable costs
- Economic environment
- Key person dependence
- Concentration of customer base
- Key supplier dependence
- Pending regulatory changes
- Pending lawsuits

Unlike the other components of the discount rate, there are no studies or empirical evidence to assist in determining the magnitude of the specific company risk premium.

Some of the guidance available in the professional literature identifies certain reasonable minimum and maximum values. According to Pratt, "the company specific adjustment is usually in the range of a negative two percent to a positive five percent, but sometimes falls outside that range, and is occasionally as high as positive ten percent. A ten percent adjustment could be warranted in extreme circumstances, such as a startup company or a financially distressed company."[13] Fishman also indicated, "the additional adjustments for size and other risk factors for a small company will range from three percent to fifteen percent. However, adjustments may be significantly greater than fifteen percent for some high-risk companies or even negative for companies with lower risk than the average small company."[14]

Thus, the guidance offered by the professional literature indicates a range of negative two percent for companies with lower risk than the average small, privately held company, to approximately ten percent for a company with greater risk than the average small, privately held company.

Trugman developed a framework to help valuation experts quantify and explain their reasoning in using the company-specific risk, if one warrants. Trugman states, "that a company-specific premium is calculated by comparing the subject company to either guideline companies, or in the absence, other forms of industry investment information."[15] Further, Trugman indicates the expert should, "itemize the relevant potential company-specific risk factors and assign each adjustment based on how much they differ from the industry baseline risk."[16]

It is important to remember, many of the characteristics often cited as reason for the company specific risk adjustment are the very attributes that generally define small companies. Therefore, adding a company specific-risk factor may be double counting the risks already embodied in the size premium adjustment. Thus, the company-specific risk should be used judiciously.

For purposes of the example in this article, I have utilized a company-specific risk premium of two percent for use in the Build-Up One method and the CAPM, whereas, for the Build-Up Two method, I have utilized a company-specific risk premium of zero percent. The reason being, the eight factors considered in arriving at the equity risk premium plus size premium combined, compare the underlying data directly to the company in arriving at the appropriate risk factor. Therefore, one can argue there are very few, if any, additional factors that still need to be considered, and pending any major factor, there should be a minimal to no adjustment for the company-specific risk factor.

12 Pratt, Shannon P., *Cost of Capital, Applications and Examples*, John Wiley & Sons, Inc., Fifth edition, 2014, page 373

13 Laro, David, and Shannon P. Pratt, *Business Valuation and Taxes,* John Wiley & Sons, Inc., 2005, page 192.

14 Fishman, Jay E., et al., *Guide To Business Valuations,* Practitioners Publishing Company, Fort Worth, Texas, 2007, page 5–25.

15 Pratt, Shannon P., *Cost of Capital, Applications and Examples,* John Wiley & Sons, Inc., Fifth edition, 2014, page 397.

16 *Ibid*

INDUSTRY RISK PREMIUM RPI

The industry risk premium introduces a measure of beta risk into the build-up equation.

The industry risk premium is calculated based on Standard Industry Classification (SIC) Codes. Duff and Phelps provides the industry risk premium codes in Exhibit 5.7 of their Valuation Handbook. The exhibit provides the industry risk premium based on using the three different ERP estimates discussed above, historical ERP, supply-side ERP, and Duff and Phelps recommended ERP.

For those that have chosen to calculate their own ERP or beta, then one would simply plug the individual components into the following formula to calculate the industry risk premium as (beta X ERP) – ERP. For example, using our SIC code of 5065, the industry risk premium according to exhibit 5.7 of the Valuation Handbook is 2.3 percent, and the beta is 1.46. Using the ERP previously selected of 5.0 percent we can calculate the same industry risk premium by multiplying the beta of 1.46 with the ERP of 5.0 percent minus the ERP of 5.0 percent [(1.46 X 5.0 percent) – 5.0 percent = 2.3 percent].

A word of caution, "these industry adjustments are valid only to the extent that the subject company's risk characteristics are similar to the weighted average of the companies that make up the industry for the SIC code shown."[17] Therefore, it is important for the valuation expert to not rely solely on the code printed by Duff and Phelps, or any other source, but to actually drill down into the companies included in the industry risk premium and to obtain their 10-K reports. It is recommended "to rely on segment profitability because stock returns are a function of profit, not revenue, and use of revenue segmenting may result in overweighting the low-profit segment."[18]

The industry risk premium is a measure of beta and should not be used within the context of any cost of equity model that already includes a beta. To do so would be double counting. Therefore, one would only use the industry risk premium in the Build-Up One method, as both the Build-Up Two method and the CAPM include a beta component.

For purposes of the example in this case study, I have utilized an industry risk premium of 2.3 percent for use in the Build-

17 Pratt, Shannon P., *Cost of Capital, Applications and Examples,* John Wiley & Sons, Inc., Fifth edition, 2014, page 181.
18 *Ibid*



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Up One method, and no industry risk premium for use in the Build-Up Two method and CAPM as these methods already have a beta component built in.

EQUITY RISK PREMIUM PLUS SIZE PREMIUM COMBINED RP_{M+S}

The equity risk premium plus size premium is also referred to as the risk premium over the risk-free rate. In its simplistic form, this represents the difference between the historical (observed) return of equities and the risk-free rate. "To estimate the historical risk premiums, the average rate of return for each of the twendy-five size-based portfolios is calculated over the same period, and then the average income return of long-term U.S. government bonds over the same period is subtracted."[19] The difference is simply a measure of risk in terms of the combined effects of market risk and size risk. In the 1990's Grabowski started studying the relationship between company size and stock returns. Although his research focused on size as measured by market capitalization, he quickly advanced to two additional areas of inquiry: whether stock returns were predicted by the measure of size other than market capitalization, or by the fundamental risk measure on accounting data.

The CRSP deciles size premium includes only a size study, whereas the Risk Premium Report includes both the risk study and the size study. The risk study is an extension of the size study with the main difference being that the size study analyzes the relationship between size and return; the risk study analyzes the relationship between fundamental risk measure[20] and return. The fundamental measures of company risk are used to distinguish these risk measures from a stock market based measure of equity risk, like beta. In addition to the twenty-five portfolios being ranked by the eight alternative measures of size as done in the size study, they are also ranked by three fundamental risk measures:

(i) five-year average operating income margin;
(ii) coefficient of variation in operating income margin,
(iii) coefficient of variation in return on book equity. The risk premium report includes detailed information about the characteristics of the companies that comprise the portfolios used to create the premia, and provides the valuation expert with a mechanism to further refine the equity risk premium and size premium portion of the cost of equity estimate by comparing to the subject company.

"Equal-weighted rather than market-cap-weighted returns are used in the formation of both the size study and risk study portfolios."[21] Therefore, it is recommended that the valuation expert applies equal weight to the metrics utilized in arriving at the combined equity risk premium and size premium. The eight metrics are discussed above in the discussion of the size premium. Since Griffin is a private company, the market value of equity and the market value of invested capital are not applicable, therefore, we have only used the following six categories:

1. Book value of equity
2. Five-year average net income
3. Total assets
4. Five-year average EBITDA
5. Sales
6. Number of employees

Using the information in the Valuation Handbook and comparing to the subject company, we have arrived at a combined equity risk premium and size premium of 13.6 percent, as shown on Table 5.

TABLE 5: COMBINED EQUITY RISK AND SIZE PREMIUM

	Book Value of Equity	5-Yr Average Net Income	Total Assets	5-Yr Average EBITDA	Sales	# of Employees
Balance for GRIFFIN	$31,174,500	$4,130,400	$47,314,100	$7,205,200	$68,473,600	$50
Implied premium	13.27%	13.32%	14.22%	14.06%	12.91%	13.91%

Average of above factors	13.62%

ERP ADJUSTMENT

The ERP adjustment is only used in the Build-Up Two method. If a valuation expert is determining the discount rate using the Build-Up One method or the CAPM, then an ERP adjustment is not warranted. The ERP adjustment is necessary when using risk premia over the risk-free rate because these premia measure risk in terms of the combined effect of market risk and size. If an expert was to use an ERP that is different from the historical market risk premium, it is reasonable to assume that the historical portfolio returns would differ on a forward-looking basis by a similar differential. Therefore, an adjustment must be made to account for this difference.

The ERP adjustment is calculated as follows: ERP adjustment = ERP that the valuation expert has selected less the historical ERP. We discussed the ERP earlier in this article and have selected to use the Duff and Phelps recommended ERP (conditional). Exhibit 9.4 of the Valuation Handbook reports the historical ERP for the period 1963-2014 to be 5.1 percent.

Therefore, using an ERP of 5.0 percent and the historical ERP of 5.1 percent we have an adjustment of -0.1 percent (5.0 percent - 5.1 percent). Alternatively, if the expert was to select the supply-side ERP of 6.2 percent, then the ERP adjustment would be 1.1 percent (6.2 percent - 5.1 percent).

One needs to remember that the ERP adjustment is only used in the Build-Up Two method and not the Build-Up One method or the CAPM. In addition, the ERP used in the ERP adjustment, if applicable, needs to be consistent with the selected ERP.

Therefore, we have used an ERP adjustment of -0.1 percent within the Build-Up Two method.

APPLICATION OF THE BUILD-UP METHOD

As we discussed throughout the study, there are two separate methods under the build-up approach. The first was the build-up method using CRSP data which we referred to as the Build-Up One, and the second was the build-up method using the Risk Premium Reports which we referred to as the Build-Up Two. In Table 6, I recap the formula and the metrics that we ascertained previously in the case study, as well as (in Table 6a) calculating the discount rate.

TABLE 6: RECAP—FORMULA & METRICS

Method	Formula
Build-Up One (CRSP Deciles Size Premia)	$K_e = R_f + RP_m + RP_i + RP_s + RP_c$
Build-Up Two (Risk Premium Report)	$K_e = R_f + RP_{m+s} + RP_c$ + ERP Adjustment

K_e = Cost of equity
R_f = Risk-free rate
RP_m = Equity risk premium (ERP)
RP_i = Industry risk premium
RP_s = Size premium
RP_c = Company-specific risk premium
RP_{m+s} = Equity (market) risk premium plus size premium combined
ERP Adjustment = an adjusted to account for the difference between the forward looking ERP that the valuation expert has selected and the historical ERP

19 Pratt, Shannon P., Cost of Capital, Applications and Examples, John Wiley & Sons, Inc., Fifth edition, 2014, page 481
20 Accounting data
21 Pratt, Shannon P., Cost of Capital, Applications and Examples, John Wiley & Sons, Inc., Fifth edition p. 476

TABLE 6A): THE DISCOUNT RATE CALCULATION

	Build-Up One	Build-Up Two
R_f	4.00%	4.00%
RP_m	5.00%	N/A
RP_i	2.30%	N/A
RP_s	3.74%	N/A
RP_{m+s}	N/A	13.62%
RP_c	2.00%	0.00%
ERP Adjustment	N/A	-0.10%
Cost of Equity (Discount Rate)	17.04%	17.52%
Cost of Equity (Discount Rate) (Rounded)	17.00%	18.00%

CONCLUSION

As can be seen using the Build-Up One and Build-Up Two methods, we arrive at very similar discount rates. In the next article, I will discuss how to apply the CAPM and WACC in arriving at the discount rates. In addition, I will compare the four rates and show how the discount rates are converted to a cap rate and then applied to an income stream. VE



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VALUATION

NACVA At Twenty-Five: An Interview with Brien Jones

By Nancy McCarthy, Senior Editor

Twenty-five years ago, the number of internet users reached one million; the Dow Jones average topped 3,000 for the first time; recording artist Prince released his thirteenth studio album, "Diamonds and Pearls." Also of note, Parnell Black was helping co-found The National Association of Certified Valuators and Analysts (NACVA).

The world has changed a bit since 1991. The number of internet users is now measured in the billions. The Dow Jones average is hovering around 18,000; and, sadly, the artist known as Prince passed away on April 21, 2016. Also in the intervening years, NACVA's membership has grown to over 7,000 members and is widely considered to be the thought leader in education and certification for financial professionals focused on valuing privately held businesses and financial forensics. This milestone will be celebrated at NACVA's annual conference in San Diego (June 8-11, 2016) at the Hotel Del Coronado, one of the most iconic resorts in the country. "The Hotel Del Coronado, by its location, its history, and its reputation, is a wonderful setting to welcome all of our NACVA members," says Brien Jones, Chief Operations Officer and Executive Vice President of Business Development.

A CELEBRATION OF ITS MEMBERS

Jones says the conference is a celebration of its members; both the pioneers who helped establish NACVA and the next generation who will take the organization into the future. "We are very proud of what we have accomplished," he says. "This is a membership driven organization. It has been built and maintained by people committed to its success." NACVA members serve on various boards, to which they are nominated and elected. Members also volunteer to be on committees and to participate in state chapters. They also lend their expertise by writing for various publications. "Our members are known for rolling up their sleeves and identifying what needs to be done. We are very proud of this."

KEYNOTE SUPERSTARS

The NACVA and CTI teams have worked diligently to make the experience memorable for the participants. "I think the theme, Strong Foundations Build Bright Futures," sums up not only our history, but it also speaks to all the NACVA audiences," says Jones. The keynote speakers definitely set the tone for the meeting. "Each speaker represents an aspect of the industry, says Jones. The keynotes are:

- Steve Forbes, chairman and editor-in-chief of Forbes Media, leads the most successful business news magazine in the U.S. His economic insights are trusted by business leaders around the world. He will be discussing the current economic situation and providing insights and strategic advice for business growth and success.
- The Honorable Judge David Laro, United States Tax Court, Adjunct Professor of Law, author, has been instrumental in establishing case law by bringing experts into chambers. He will be discussing the new tools (such as "hot-tubbing") judges are using to get through the conflicting positions various experts hold.
- Mel Abraham, CPA, ABV, ASA, CSP, has over two decades experience as a valuation expert and business strategist. He will be discussing how to prepare expert witnesses in the evolving environment of court testimony.

DYNAMIC CONFERENCE SESSIONS

NACVA has approached the member sessions a little differently this time out. According to Jones, "We want this to be more of a hands on session. We want members to come away with definitive ways to improve their business communication and their practice management." The goal is for members to have that "aha" moment that they can bring home and apply to their practice. "We are hoping there will be more of a two-way conversation between the participants and the speaker, "says Jones.

When asked about the future of NACVA and business valuation, Brien Jones, does not hesitate. "The world is changing so quickly. Certainly, technology has made an impact on how we conduct our business. But the world economy also has changed. The profession is becoming quite global as emerging economies feed into the U.S. economy. To meet these opportunities and expand the Certified Valuation Analyst (CVA) and Master Analysts in Financial Forensics (MAFF) designations globally we have launched international chapters in Africa, Canada, Europe, the Middle East, and Taiwan. NACVA's global membership has a great opportunity to reshape the industry based on the opportunities in front of us and our history behind us."

OPPORTUNITIES TO NETWORK

The conference will also provide participants with the opportunity to catch up with old friends and network with new ones. "The location could not be better," Jones enthuses. "There will be a reception on the beach on the first night, there will be dine arounds, and the ability to take trolleys into parts of historic San Diego. There will be something for everyone." VE



Brien Jones is a seasoned association executive with extensive professional experience in continuing professional education management, online/distance learning, business development, member recruitment/retention, operations management, conference and event planning, marketing, graphic design, public relations, social media strategies, copywriting, and supporting association governance. He has been employed with the NACVA and the CTI for nearly twenty years supporting the organizations and their industry partners in a leadership capacity.

BOOK REVIEW

Equity Value Enhancement: A Tool to Leverage Human and Financial Capital While Managing Risk

By Carl L. Sheeler
J. Wiley and Sons, Wiley Finance, Englewood, NJ, December 2015, 368 pages

Reviewed by Michael Gregory, CVA, ASA

It was a pleasure to fully read[1] and review the book *Equity Value Enhancement: A Tool to Leverage Human and Financial Capital While Managing Risk* by Dr. Carl L. Sheeler. He has an interesting biography and set of experiences that allows him to provide us with expertise as a thought leader, solution provider, and business valuer. As a servant leader,[2] he shows the reader how to take specific actions as a business owner or business valuer for improvement going forward. With twenty-five plus years of experience, thousands of appraisals, over 170 expert witness court engagements, and having given over 300 presentations, he shares what he has learned to make you even better at what you do.

As a business valuer, if there is one book you want to read this year, this is it. Why? As a business valuer, do you see yourself simply as a technician? Or, do you think of yourself and apply your skills as a value added partner with your client and other advisors who is there to enhance value? If you think of yourself in the latter, and you want to enhance relationships with a broader spectrum of individuals to expand your network, explore different ways of thinking about risk, and expand your horizons with respect to how culture impacts governance, then this book is for you.

The eleven chapters are packed with valuable insights, lists, and bullet points of key activities and steps you should be considering as a business owner, business developer, business appraiser, and entrepreneur. Dr. Sheeler provides down to earth commentary that at once is practical and easily understood—and at the same time, strategic and insightful with concise commentary "case in point" examples that bring home the key elements being offered in the chapters.

Throughout the book, Sheeler articulates how "Governance, Relationships, Risks, and Knowledge (GRRK) allows the reader to become a strategic value architect and chief of staff who not only measures, but can manage, facilitate, create, and maximize company intangible assets through the alignment of human and financial capital." Isn't that what you and your clients want?

This book speaks to me. On the one hand, it reaffirms the good things I am already doing. On the other hand, it points out additional areas for consideration and improvement. For these reasons, the book provides additional value to me and I am sure it will for you too. By applying the actual questions presented in the text to your firm and with clients, I believe parties in both venues will see their work in a new light. For example, Sheeler poses questions well beyond the financials such as:

- Is revenue/profit more important than value?
- How will strategy be communicated, executed, and governed to achieve stability and growth?
- What assets and measures are relied upon to weigh risk/opportunity and value?
- What are the governance, relationship, risk, and knowledge gaps?
- How do the founder, family, and advisors see capital (human versus financial)?

By asking these and numerous other questions presented in the text, I believe you will be able to differentiate yourself from the herd, and see ways for you to be able to provide additional value added services to clients.

By focusing on a collaborative framework of relationships and connections, he points out that we as business valuers have a lot more to offer beyond our technical know-how and

1 Note: I reviewed two chapters of the book before it was released.

2 A servant leader is a leader that listens to and works with his followers to carry out the mission considering customer satisfaction, business results and employee satisfaction. See additional commentary in *The Servant Manager* at www.mikegreg.com/books.

typical fee-for-service mindset. He offers business owners insider tips for finding good appraisers and what constitutes a thorough appraisal. Do you fit that bill? He points out the fallacy of using rules of thumb or going with the least expensive alternative. If this is an issue for you with your competition, you can learn some valuable lessons here.

On a personal note, beyond the value presented in the book, I want to point out two additional elements:

> If you didn't get value from this book, return it in new condition in sixty days with the receipt; the full purchase price will be refunded, no questions asked. If it has value, feel free to share. All proceeds received by the author will go to a 501(c)3 which will benefit veterans with combat PTSD through the use of equine and canine therapy.

As a former marine combat officer, he really puts his money where his mouth is with this additional act of patriotism. VE



Carl L. Sheeler, PhD, ASA, is the managing director and global group leader of family office and business strategies at Berkeley Research Group, LLC—a 900+ staff global business litigation and advisory services firm. He is also the founder of Business Valuations, Ltd./ Allison Appraisals & Assessments, Inc. and co-founder of Privatus CI3O Services, LLC. He has performed more than 1,200 high-profile litigations, valuation, and restructuring engagements from midmarket to national companies.

Mr. Sheeler is also a Manager of the Two Bears Ranch, LLC, formed to receive the proceeds from the sale of this book which will be used to serve combat PTSD veterans and at-risk horses and dogs. They will be healed through equine and canine therapy. Donations, grants, and ranch operation revenues will also subsidize this cause. If interested, contact Mr. Sheeler at his website at www.carlsheeler.com or www.twobearsranch.com.



Michael Gregory is the founder of Michael Gregory Consulting, LLC and now Michael Gregory Institute –Tax Topics and – Leadership Topics. He has authored nine books and fourteen videos that may be viewed at www.mikegreg.com. Mr. Gregory also mediates and conducts valuation reviews. E-mail: mg@mikegreg.com.





ACADEMIC REVIEW

Contemporary Research in Valuation and Forensic Accounting

By Peter L. Lohrey, PhD, CVA, CDBV

The purpose of this column is to provide the readers of *The Value Examiner*, summaries of contemporary research in valuation and forensic accounting. The manuscripts covered are selected from numerous academic research outlets that include relevant topical coverage of valuation and related forensic accounting issues. The objective is to illustrate the core of this novel research while increasing awareness among the community of the subject matter.

Readers are encouraged to send relevant manuscripts or working papers for consideration to Jim DiGabriele, PhD, at Montclair State University jim@dmcpa.com or digabrielej@mail.montclair.edu with "**Academic Research Brief**" in the subject line.

MASTERS IN FEDERAL TAX COURT CASES: THE ROLE OF SPECIAL MASTERS AS IDENTIFIED IN COURT OPINIONS

Authors: Brigitte W. Muehlmann and Priscilla A. Burnaby (Bentley University)
Source: http://web.nacva.com.s3.amazonaws.com/JFIA/JFIA-2015-2_1.pdf

Summary

This paper examines the various roles of special masters and suggests that forensic accountants can serve as special masters in federal tax cases across all courts. It is the authors' third article which studies the services for which experts are retained in tax cases as disclosed in court opinions. It uses a case survey archival research method to present the results of the authors' analysis of the trends in the use of special masters. The article also looks at who the special masters were and what jobs they held. Finally, this paper looks at what assignments were performed by special masters and what the appeals challenges were—as related to special masters.

Literature Considered in the Study

It is a well-known fact that when U.S. courts face judicial limitations, deficiencies in the established adjudicatory system, or flaws with parties or counsel, they may appoint special masters (Brazil, 1986). It is important to note that, given these situations as they stand today, special masters can only be appointed in civil matters. They cannot be appointed in criminal court trials.

Section 53 of the Federal Rules of Civil Procedure (Fed. R of Civ. P. 53) provides for the oversight of the appointment of special masters, their authority, actions available to the parties on a master's order, report, or recommendations.

Fellows and Haydock (2005) portrayed federal court special masters as a critical source of increasing need in complex litigation and predicted that special master appointments would become more frequent in years to come. Both tax and patent law are specific areas where special masters have been used with increasing frequency. The Legal Information Institute (2013) pointed out that the role of a "special master" is clearly different from a "master" in that, a "special master" executes direct actions on behalf of the court, while a "master" performs primarily an investigative function that consists of collecting evidence or documents. The authors go on to point out that the Academy of Court-Appointed Masters (2013) website listed accounting as a subject of veteran special masters.

Pakenham (2004) describes how the Tax Court of the United States was formed in 1942. It consists of nineteen judges, and they are all appointed by the President of the U.S. By 1986, the filings in the Tax Court reached an all-time high due to tax shelter litigation. As a result, the Tax Reform Act of 1986 included Internal Revenue Code (IRC) Section 7443A, which allowed a Chief Judge in the Tax Court to appoint a Special Trial Judge as a special master. Rule 183 under Title XVIII outlines the powers of Special Trial Judges

Design and Execution of the Study

This article uses a survey of tax cases as an archival methodology. The tax court

database, WestlawNext, was searched to find cases where special masters were used. A total of 931 tax cases were analyzed from 1913 through June 5, 2013. This led to forty-one qualifying cases. Next, twenty-one "published-unpublished" opinions from the tax-only databases CCH IntelliConnect, RIA ThomsonReuters Checkpoint, and Tax Analysts Research Libraries were added. Finally, seventeen cases from the "Rule 183" search of Tax Court cases yielded a total of seventy-nine cases which qualified for use in the analysis.

The authors pointed out that even though the seventy-nine cases covered almost nine decades, they all had special master assignments that could be carried out in the future. They also stated the paper could not offer an accurate statistical evaluation of their results.

Digest of Findings and Conclusions

Very little information about special masters' jobs or occupations was disclosed before 1980. The results presented in Table 8 revealed fifty-seven percent (forty-five) of the seventy-nine cases disclosed the special master's job or occupation. Accountants were identified in only two cases that were decided from 2001 to 2003. (This represents the use of an accountant as a special master approximately 4.4% of the time when the special master's job or occupation was disclosed). One was a retired partner from a large international accounting firm and the other was an Attorney-CPA. The authors believe this indicates that forensic accounting is not only a growing field overall, but that the expertise of forensic accountants has been sought for an additional role that was previously reserved for other experts.

This study showed that special masters have been used in federal tax cases for ninety years as pre-trial, trial, and post-trial consent masters in a variety of different assignments. Most of the tax cases where the use of special masters was disclosed were tried in district courts. The majority of the tax issues pertained to individual income taxes. The second and third most frequent issues involving special tax masters centered on corporate income taxes and tax collections.

The authors found support for Crumbley et al., (2011) finding that much of the litigation support work of forensic accountants occurs in the pre-trial discovery stage. They point out that topics for future research should further define the characteristics, relevant skills, objectivity, prior experience, education, and training requirements needed for acceptance by the courts to be appointed as special masters. This research would extend prior work about these topics performed by Poneman (1995), Crumbley and Russell (2004), Ricchiute (2004), DiGabriele (2008 and 2011), Heitger and Heitger (2008), Krancher et al., (2008), Davis et al., (2009), McMullen and Sanchez (2010), Bressler (2012), Fenton and Isaacs (2012), Misuraca and Weinstein (2012).

FORENSIC ACCOUNTING EDUCATION AND PRACTICE: INSIGHTS FROM CHINA

Authors: Zabihollah Rezaee (University of Memphis), Daniel Lo and Michael Ha (Xi'an Jiaotong-Liverpool University), Alexis Suen (Director at Pro-Fit Industrial Co. Ltd.)

Source: http://web.nacva.com/JFIA/Issues/JFIA-2016-8.pdf

Summary

This paper has three purposes: 1) to describe the forensic accounting environment in China, 2) examine the demand for and interest in forensic accounting practices and education in China, and 3) present the most relevant forensic accounting topics to integrate into the global business curriculum. The authors conduct their analysis in two stages. First, they examine the forensic accounting environment in China. Second, they conduct a survey of 167 Chinese undergraduate seniors in Financial Mathematics at Xian-Jiaotong Liverpool University in Suzhou, China and 123 graduate students at SKEMA Business School's Chinese campus. This resulted in survey data collected from 186 Chinese students and 114 international students. (All of the international students were graduate students. The Chinese student breakdown was: ninteen graduate students and 167 undergraduate students.)

The results showed that: 1) the majority of both Chinese and international students expect future demand for, and interest in, all three areas of forensic accounting to increase along with greater future demand for litigation support; 2) forensic accounting education should be integrated into both undergraduate and graduate accounting programs, with more preference for graduate-level forensic accounting courses; 3) corporate governance plays an important role in preventing and detecting financial reporting fraud (FRF); 4) anti-fraud deterrence, prevention and detection education, and practice should be integrated into the business curriculum; and 5) the majority of the twenty-one suggested forensic accounting topics (over seventy percent) are considered important by both Chinese and international students for integration into accounting and business curricula.

Literature Considered in the Study

The authors point out that the three common areas of forensic accounting practices in Anglo-Saxon countries

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LITIGATION CONSULTING

Court Corner

By John O'Grady, MSA

MARITAL PROPERTY

Faber v. Faber

2016 IL app (2d) 131083, February 26, 2016
Appellate Court of Illinois, Judge McLaren

In this appeal, Mark Faber contended with trial court's allocation of property and debit in its order of dissolution of marriage. He disagreed with specific valuations and distributions ordered by the trial court regarding his: 1) nonmarital 401(k) retirement account; 2) Employee Stock Ownership Plan (ESOP); 3) phantom stock that he had received by virtue of his ownership interest in Chicago Metallic Products (CMP), at which he was employed; and 4) subordinated notes that he held from CMP. The trial court found that "an award of property in lieu of maintenance is warranted, especially when there is sufficient property available to disentangle the parties" and to allow Carol Faber "to live at a level she enjoyed during the marriage." The trial court awarded fifty-five percent of all marital property to Carole and forty-five percent to Mark.

In regards to the 401(k), the trial court determined that all of the appreciation of Mark's Fidelity 401(k) account was marital property. Mark contended this, stating that the parties stipulated in writing Mark became a participant in the 401(k) plan before the marriage. Mark contributed annually during the marriage. Carole's expert attempted to determine the marital and nonmarital portions of the account, but could not without statements relating to the asset from the date of marriage forward. These statements were not provided.

Before the marriage, Mark owned shares of stock in CMP. During the marriage, as part of corporate restructuring, all shareholders sold their shares back to CMP, causing the company to be wholly owned by the newly created ESOP. Mark received three subordinated notes, but the planned issuance of phantom stock did not materialize. When Mark became CEO of CMP in 2006, he implemented the phantom stock plan. Between 2006 and 2011, Mark received phantom stock in five separate tranches. Mark argued the testimony during trial "overwhelmingly" showed that the stock was issued for "the sole purpose of restoring the shareholders equity that Mark and the other two concerned shareholder lost as a result of the exchange for subordinated notes." These subordinated notes were also paid, net of shareholder loans, when CMP sold in 2011.

The appellate court affirmed the lower court's judgment for the following reasons: 1) Court did not err in determining that all of the appreciation of the 401(k) was marital property under 750 ILCS 5/504 because the ruling was based on credible testimony, and the husband failed to present evidence regarding the specific earnings of the nonmarital funds in the account; 2) 100 percent of the increase in the value of the stock account was marital because evidence ascribed the increase in the value to "other assets" acquired during the marriage, no other calculation was feasible, and the husband failed to supply necessary documentation.

Franks v. Franks

2016 Tenn. App. LEXIS 152, February 29, 2016
Court of Appeals of Tennessee, Judge Gibson

The appeal was brought by the husband in this matter, Ronald Franks, regarding several factual findings relative to alimony, including the wife's (Cathy Turnbo Franks) ability to secure employment, husband's ability to earn in the future, the

aware of attorney's fees to wife, and the value of several marital assets divided in the property division, including the value of an LLC jointly owned by the parties. Cathy Turnbo Franks also appealed the trial court's determination of value and the division of the parties' joint interest in the LLC, which the trial court awarded to the husband without assigning a value.

The parties jointly owned a one-half interest in Ronald Franks Construction, LLC (the LLC), a construction business. The wife testified she believed she was a "member or a partner" of the LLC. She stated she was involved in its operations as a bookkeeper when the LLC began. She also testified as the LLC grew, she could no longer be the bookkeeper due to limiting factors. Although she no longer kept the books, she testifiedt she "helped do stuff in the office, and cleaned the office, and done a lot of things." When asked about the LLC's financial status, the husband testified, "it's not good." He reasoned the decline was due to the economic downturn and was only able to stay in business due to credit lines and borrowed money. The husband testified the value of the LLC was negative $218,000.

The trial court noted the wife did not put any proof to contradict husband's value. The court stated it did not believe the value of the LLC to be negative $218,000, and it thought the "business is making a lot of money, a lot more than what was testified to here today, and the lifestyle of the parties, at least in the continued purchases of [husband] during the pendency of the divorce indicates to me that, you know, he has a great credit score." The court awarded the business to the husband without dividing its equity, and without placing a value on the LLC.

The lower court's judgment was vacated and the case was remanded for a re-hearing by the Court of Appeals. The Court of Appeals held that Tennessee law is clear in that trial courts must place a reasonable value of marital property that is subject to division, citing numerous court cases. Because of the trial court's failure to include a value of the LLC, the trial court's rulings on the division of marital property, and the trial court's ruling with regard to alimony, were vacated; the trial court was remanded for entry of an order specifying the basis for the trial court's determination of the LLC's value. Remaining issues presented by the husband were not addressed, as the re-hearing would affect such conclusions.

TAX COURT

Kardash & Robb v. Commissioner

T.C. Memo 2015-51; March 18, 2015
United States Tax Court, Judge Goeke

Florida Engineered Construction Products Corp. (FECP) made precast concrete products often used in home construction. During the years at issue, four individuals owned all of FECP's stock: petitioner William J. Kardash, Sr. (8.65 percent); petitioner Charles K. Robb (1.13 percent—not until 2004); FECP's president John Stanton, and its board chairman, Ralph Hughes, owned equal shares of the remainder. Messrs. Stanton and Hughes were involved in all aspects of FECP's business, and as the majority shareholders, they controlled the direction and management of the company. Mr. Kardash is an engineer and was primarily involved in FECP's operations. He was responsible for the company's processes and production decisions. Mr. Robb managed the company's sales team. Neither petitioner was involved in the company's financial matters.

During the housing boom in Florida in the early 2000s, FECP earned large profits on which the company paid no federal income tax and its majority shareholders siphoned substantially all of the cash out of the company. The IRS determined tax deficiencies, penalties, and interest against FECP for the period totaling more than $120 million, which FECP did not have the ability to pay. An agreement was put in place in which FECP would pay $70,000 monthly towards the penalty. Among other things during the investigation, fraud was uncovered regarding the transfer of funds and fictitious loans. As a result, the IRS attempted to recover funds from the petitioners for the years 2003–2007 under Section 6091(a) and the Florida Uniform Fraudulent Transfer Act. The petitioners, who argued that if the court finds that FECP was insolvent during the years at issue, they should not be liable as transferees because the insolvency was caused by Stanton and Hughes fraudulently stripping the company of cash. As a result, the IRS's valuation expert utilized the asset approach, which determined the company to be insolvent for all years in question. The petitioner's valuation expert utilized the discounted cash flow, guideline public and guideline transaction methods, which concluded all scenarios only became insolvent in 2007.

The tax court ruled that the respondent did not establish the transfers for 2003 and 2004 were fraudulent under Florida law. The tax court concluded the respondent established

the transfers for 2005 through 2007 were fraudulent under Florida law. The court also concluded that the corporation was insolvent in 2005, seemingly siding with the IRS's valuation expert, which gave the most weight to the asset approach. Accordingly, the court held the petitioners liable as transferees under Section 6091(a) for the years 2005, 2006, and 2007.

SHAREHOLDER DISPUTE

In re: Discontinuance & Disposition of PK Smith Motors, Inc.

2016 LA app 50,357-CA; March 9, 2016
Court of Appeal, Second Circuit, State of Louisiana, Judge Calloway

This matter involved a family dispute between a nephew, as executor of his late father's estate, and an uncle concerning a family-owned corporation. Bradley Kyle Smith (Bradley), independent executor for the Succession of Perry Joe Smith (the estate), appealed a judgment that denied his petition for the discontinuance and disposition of P.K. Smith Motors, Inc. (PK Smith or the corporation), and ordered specific performance of a 1984 shareholder agreement under which the estate was required to sell its shares back to the corporation. After valuing the corporation at $1,000,000 and determining $500,000 to be the value of the estate's fifty percent ownership, the trial court that the decedent, Perry Joe Smith, was indebted to the corporation for $163,469.65. This amount was offset against the court's valuation of the corporation, thereby reducing the buyout of the estate's shares.

The lower court's judgment was affirmed by the appellate court. The appellate court held that: 1) a shareholder agreement was properly enforced as it addressed the sale of shares upon the decedent's death and established restrictions on the transfer of the shares upon the decedent's death; 2) the refusal to proceed with dissolution under form La. Rev. Stat. Ann. § 12:143(C) was proper as the executor did not want to shut down the car dealership operated by the close corporation as the close corporation was willing to buy the decedent's shares; 3) the valuations of the close corporation at $1,000,000 and the estate's fifty percent interest at $500,000 were not manifestly erroneous; 4) the decedent's unpaid balance to the close corporation was a simple loan that prescribed three years from the time of each advancement; 5) the prescribed claims for money lent to the decedent were properly offset against the purchase price for the estate's shares. VE



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are: litigation consulting, expert witnessing, and fraud examination—Rezaee, et al., (2004). They also cite the work by Davis, Farrell, and Ogilby (2009) which surveyed 126 attorneys, 603 practicing CPAs, and fifty accounting/auditing professors in the United States to gather perceptions of the characteristics and skills needed by forensic accountants. Their results found that the three vital traits forensic accountants must possess were: analytical skills, detail-oriented workmanship, and ethical behavior.

Unfortunately, the authors overlooked a seminal paper by DiGabriele (2008). He conducted a survey of 252 practitioners, academics, and users of forensic accounting services. His results indicated practitioners and academics agreed that critical thinking, unstructured problem solving, investigative flexibility, analytical proficiency, and legal knowledge are the most important skills for forensic accountants. In my opinion, this oversight creates a huge gap in the paper's review of relevant literature on the skills needed by forensic accountants.

Forensic accounting education and practice research in China is rare. Zhang and Zhang (2010) and Zhang and Bohai (2010) reported that the promotional strength of forensic accounting in China was insufficient, with low social awareness, based on a survey of Chinese professionals in 2005–2006. Hao (2010) reported that the Shanghai Forensic Accounting Identification Committee has been concerned about public interest in addressing the accounting materials in cases including economic crime, economic dissension, and civil disputes.

Design Methodology/Approach

Two methods were used to collect data on the supply and demand for forensic accounting education in China. The first method consisted of a content analysis of several course syllabi (they didn't say how many) to determine how much forensic accounting is currently supplied at Chinese universities. The second method consisted of conducting a survey of the 186 Chinese students and 114 international students enrolled in two courses taught by the authors.

Digest of Findings and Conclusions

The results are presented in three categories: 1) the international horizon for forensic accounting practice; 2) the method of integrating forensic accounting education into the business and accounting curricula worldwide; and 3) topical content and coverage of forensic accounting education.

With regard to the future demand for and interest in forensic accounting practice, Chinese students expect higher growth in the three areas of forensic accounting practices (litigation support, expert witnessing, and fraud examination) than did international students. More Chinese students than international students expected that the demand for and interest in litigation support and expert witnessing would be greater than the expected demand for fraud examination. This strikes me as somewhat illogical, as fraud examination is quite often the first step in providing forensic accounting services.

The results for the second category, which focused on the method of integrating forensic accounting education into the business and accounting curricula worldwide, showed a majority of both the international and Chinese students believed that forensic accounting courses should be offered at graduate, undergraduate and/or both levels.

The results for the third category, the topical content and coverage of forensic accounting education revealed both groups, Chinese and international students, agreed that Corporate governance played an important role in preventing and detecting fraud.

The authors conclude by recommending universities that offer, or plan to offer, a stand-alone forensic accounting course or infuse forensic accounting-related topics into the business curriculum, consider a module approach in designing their courses to cover the three areas of: fraud investigation, litigation consulting, and expert witnessing. VE



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PRACTICE MANAGEMENT

Practicing Solo

"Practicing Solo" features interviews with our industry's seasoned sole practitioners. If you are itching to join the solo ranks, or striving to be more efficient and effective in your established one-person firm, this column offers you practical advice, steeped in experience from the trenches, that can move you forward.

By Rod P. Burkert, CPA, ABV, CVA

INTERVIEW: MICHAEL GREGORY

I hope you enjoyed last issue's interview with Bill Ditty. Our interview series continues, this time featuring Michael Gregory, CVA, ASA. Michael hails from Roseville, Minnesota—smack dab in the middle of the Minneapolis-St. Paul Twin Cities.

After retiring from the IRS, Michael launched his solo practice in August 2011, practicing under the banner of Michael Gregory Consulting, LLC (mikegreg.com). With respect to business valuations, he conducts report reviews and assist parties with federal tax filings, audits, appeals, and litigation. His consulting sweet spot is resolving issues between parties (an interesting way to look at our work, yes?). He generally works with companies having five million to one-hundred million dollars in revenue. Michael is also a qualified mediator for the Minnesota Supreme Court.



Michael Gregory

This is one of the most encompassing interviews I've had the pleasure to conduct, and it was inspiring to see what one person can accomplish in our industry. I hope you take the time to read everything that Michael has to say and research some/all of his links.

Rod: What was your first year like, and what would have made it better?

Michael: Having worked for the IRS for twenty-eight years at all levels of management and having taken the lead in the business valuation area in my last eleven years, I was not sure what I was going to do when I "retired."

Two Big Four firms spoke to me about working for them and doubling my pay. I asked them what they wanted me to do. They told me—work with large companies who understand the IRS systems and how to use them to their advantage. I wasn't interested.

But the experience gave me some ideas. I realized that I wanted to: 1) parlay my valuation experience and help smaller businesses who don't understand those IRS systems and, as a result, get caught up in contentious situations; and 2) expand my IRS management experience in conflict resolution and serving others.

Also around this time, I was fortunate that a former IRS employee leaked the "*Discount for Lack of Marketability*" paper I championed, and that Eva Lang found it on the Internet. She invited me to join Jim Hitchner and Jim Alerding on a webinar the week after I retired from the IRS. As a result of that guest appearance, I was asked to review four BV reports, and shortly thereafter, I started Michael Gregory Consulting, LLC.

When I prepared to launch my firm, I thought about who I knew and who I would contact for advice. I felt I needed to talk to several individuals who I really respected and ask for their guidance. I then took steps to carry out certain actions after listening to the feedback from my mentors.

One of my mentors really emphasized writing in order to gain visibility. I took that to heart. About two months into my new business, a publisher spoke with me about writing a book. I proposed twelve chapters associated with the topic of

How to Work with the IRS. We dropped some chapter ideas and added others.

I pre-announced the book's publication to Estate Planning Councils, state CPA societies, NACVA, ASA, and IBA state chapters, state bar associations, and specifically targeted law firms. As a result, I was asked to make over fifty presentations around the country. The book is now in its second edition [http://mikegreg.com/how-work-with-the-irs-2nd-edition].

I also began venturing into writing in various journals and have now written fourteen articles. That book and the various articles really helped launch my practice. (Note: don't just take my word regarding the career benefits of writing; see the actual research verifying this from *QuickRead* [http://quickreadbuzz.com/2015/12/02/points-the-way-to-more-referrals/].)

Also, I had been involved in big-picture strategic planning at the IRS for the engineering and valuation program, the economist program, and other field specialist programs. Given that experience, I developed my own strategic plan that looked two years out and asked myself: What would it take to get me there? What do I need to do?

And ever since, I pause at the end of each quarter and evaluate metrics associated with customer satisfaction, business results, and my own satisfaction. I look out two years from each quarter end and ask: What do I need to keep doing? What do I need to stop? What do I need to start? This helps me focus and adjust to the changing needs in my work environment.

I know this is a long answer to your first question, so let me summarize. Key highlights of my first year were:

- Searching out great mentors,
- Carrying out actions based on their advice,
- Developing a business plan,
- Executing the plan and adjusting for what worked and what didn't,
- Focusing on the long term (two years out),
- Becoming visible by writing and speaking,
- Developing a website that conveys who I am and what I do, and
- Including information on my site that is continually updated and helps others.

As you can see, I have a passion to learn and to share that knowledge. I have a passion to be a servant manager. Since starting my firm, I've written ten books and spoken nearly 200 times. Giving away what I have learned and being there to serve others has come back to me in spades, and I have been blessed with my solo practice success.

Leaving the governmental bureaucratic environment, I had real apprehensions about what it would be like to be in the private sector and to be on my own. I think those apprehensions held me back initially. Today I have confidence, know how to market my services, and am truly an entrepreneur. In retrospect, I could have been more assertive than I was in my first year.

Rod: Do you practice in a specialized niche today?

Michael: When I started my practice I was a "supply-push" service provider, meaning I supplied certain services and pushed them on my clients. So in the beginning, I was a negotiator (primarily on IRS issues), mediator, and report reviewer. With experience, I became a "demand-pull" provider of services based on the wants/needs of my clients and what I wanted to do. So as time went on, I became a writer and speaker, and provided strategic planning services.

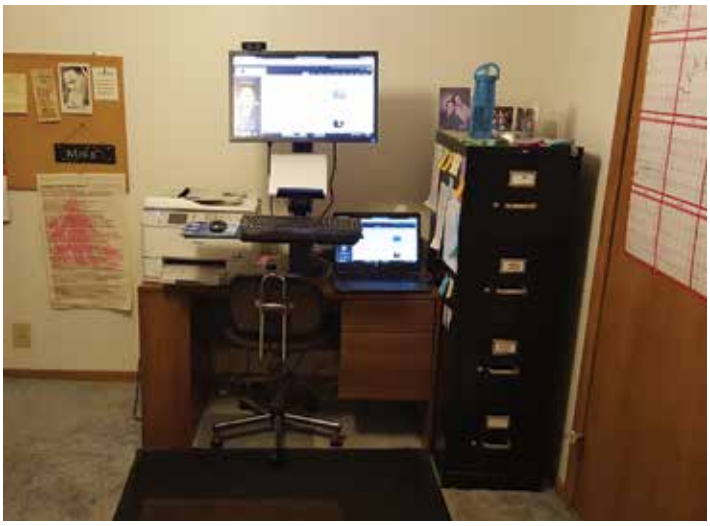
As you might guess, I review valuation reports for federal tax issues and other specific requests where I have expertise. Many of my clients need assistance with understanding IRS systems or the dynamics of the IRS employees they work with, either on estate and gift tax issues or with the Large Business & International Division for valuation, research credit, international tax, and transfer pricing matters.

I provide services as a negotiator or mediator for clients to help them resolve issues business-to-government (IRS), business-to-business, or within businesses (shareholder disputes, family owned business matters such as selling the business internally, and boards of directors seeking advice in areas of conflict resolution or strategic planning).

One of my clients told me I am not a problem solver, but a solution provider—and that seems to nicely sum up what I do. I find I can either: 1) expand a client's thinking to help them solve their concerns; 2) help them directly because I know how to accomplish the task; or 3) put them in touch with someone in my network who can help.

Rod: What has been your best marketing tactic?

Michael: Initially, one of my mentors told me I needed to physically get in front of at least five people a week and explain where I thought I could add value. How do I do that? He suggested that I reach out to law firms with at least ten but less than 100 attorneys in the Twin Cities via e-mail, phone call, or a personal note. He suggested that I offer to take them out to lunch or coffee so they could learn to like me, trust me, and know that I am competent. As a result of this tactic, I had four clients in two months. Today, I am working with six of these firms on a regular basis.



Michael's office is a model of organized efficiency.

I also reached out to more distant geographic areas where I had contacts. I found several firms that brought me in for interviews. We went to lunch and initiated relationships. Within 90 days, I had my first retainer in another metropolitan area.

I also write a blog [http://mikegreg.com/blog/] with information to help with IRS issues, negotiation and mediation subjects, and leadership topics. I include some of these in my *Constant Contact* newsletter. However, you need a list of contacts for your mailing list. Make the effort to start on that today if you have not done it already and update this list constantly.

As I indicated above, there is no question that my writing and my speaking engagements heighten my visibility and bring in clients.

Just as an FYI, writing a book takes considerable time and effort. And I make minimal money on my books with my traditional publisher. In this arrangement, a writer typically receives a fifteen percent royalty after expenses. You can take it from there, but I will tell you, my book earnings account for less than five percent of my revenue. I could always self-publish, but I decided I didn't also want to be in the business of taking orders and shipping books…that's not part of my plan.

But I write books because I want to share what I have learned and help others. That truly is my motivation. Some event organizers, having heard me speak, ask me to not promote my books on stage. I understand that. I honor that by not mentioning my books in those presentations, even though I truly believe they offer insight and value, and will save others time and money.

Rod: How do you price work?

Michael: One of my mentors told me to only have one hourly rate. He advised me that with more than one rate I would always be haggling with clients. That was good advice. But with time and experience, I have changed my view on this.

I have one hourly rate for my standard work; I double that for litigation support. And since I work nationally and internationally, I adjust my rate for geographic areas that expect a higher fee to demonstrate competence. I also have a fee structure for my speaking engagements.

Each January I revisit my fee structure and, looking at my business plan two years out, and make appropriate adjustments. I share the new fee structure with existing clients; to date, this has not cost me a client.

Rod: How do you differentiate yourself from larger firms?

Michael: Being able to add value where others don't is the key. I have a unique skill set as a negotiator, mediator, and business appraiser. Plus, having worked for the IRS enables me to provide a particular type and quality of service that others can't. Then, frankly, success breeds more success.

I encourage business appraisers to read Chris Mercer's book, *Unlocking Private Company Wealth*[1]. Why? I believe firms looking for ways to serve a client business by employing business valuation techniques that add value, have a tremendous opportunity.

Exploring related opportunities is something else that drives me. My clients now ask me to not only assist with negotiations and mediations, but also to teach management and then the employees how to address a host of leadership issues. You can see the topics I cover at my website [http://mikegreg.com/leadership].

And interestingly, I am paid more today to tackle these leadership issues than to provide business valuation services. The lesson here? I listen to my clients and adapt to their needs.

Rod: Do you work from a home office or an "office" office?

Michael: I work out of a home office. I have a nice view out a sliding glass door onto my patio and backyard. I feed some wild critters that like to frequent the lawn on a daily basis. I made a decision that I don't really need to have a prestigious office location and incur those expenses…and my ego is fine with that. On the occasions that I really do need a professional

1 Christopher Z. Mercer, *Unlocking Private Company Wealth: Proven Strategies and Tools for Managing Wealth in Your Private Business*. Peabody Publishing, 2014, 250 pages

conference room, I make arrangements with my accountant to use their facilities!

Rod: What is your current mobile device?

Michael: I have a Samsung Galaxy S6 on Verizon's network.

Rod: Describe your current computer workstation set up.

Michael: I use an HP laptop and a variable stand-up work station. I stand nearly all of the time. I have a locked file cabinet on the right side of my workstation and an Epson printer/scanner on the left. On my bulletin board, I have a number of quotes and photos to help keep me balanced and humble.

Rod: Besides your phone and computer, any office hardware or software that you just couldn't live without?

Michael: QuickBooks and Windows. I did not upgrade to Windows 10 because I read there may be difficulties between the two. Taking the *QuickBooks* tutorials and, on occasion, hiring someone who really is an expert for an hour or two, works out extremely well. My overhead time for billing is about two hours a month. I bill at the end of every month and follow up in thirty days if I have not received payment. I have never had any invoices over forty-five days old or bad debts. It pays to stay on top of these.

Rod: What do you listen to while you work?

Michael: I do not listen to music or the radio while I am working. I have learned from neuroscience that we do not multi-task, rather we do one thing at a time. I schedule times to focus on specific activities and this makes me far more productive.

Rod: What tool(s) do you use to manage your to-do list?

Michael: Each day I pull out a fresh pad of paper and write down the day of the week and date on the upper right hand side of the pad. On the first line I write VMS (for voice messages) and e-mail. I listen to my voice messages and read my e-mails. My goal is to touch an e-mail and/or any piece of paper only once. I make decisions quickly and file e-mails into folders. Then I look at my calendar, focusing on the week ahead, and write down what I see as my tasks for the day based on what was not done yesterday and what I want to do today. I typically spend about an hour on voice messages and e-mail and setting priorities for the day. I typically answer the phone and reply to e-mails at break times during the course of my day, unless I am doing lower priority work that will tolerate an interruption. I respond to any calls or e-mails within twenty-four hours.

Rod: What method/system/tool do you use to stay organized?

Michael: I am a very organized person. With my paper-made to-do list, I prioritize those items and address them according to my schedule for the day. When someone calls, I have four blank pads of paper ready. I write down who called, the date and time of the call, and take notes while I listen. After the call I make a note of the duration—I bill by the minute. I keep track of all phone conversations whether billable or not. If you called me three years ago, it is likely in my files. If the call is from a client, I document it in their billing spreadsheet. When I bill on *QuickBooks* at the end of the month, I simply attach the invoice and the client's workbook with the monthly spreadsheet of billing time. If the client wants to see the back up for the workbook, I have all of our calls with my notes, plus my work papers.

Rod: Early bird or night owl—what's your sleep routine?

Michael: I am an early riser. I know from neuroscience that the average person needs seven to nine hours of sleep every night and that consistent wake up times are much better for our brains.

While I am a higher energy person than average, I believe I need less sleep than average.

I typically go to bed about 9:00 or 10:00 p.m. and pray and meditate for about twenty minutes.

I wake up at 4:15am and start my morning routine; which includes stretching, yoga, exercise, and a healthy breakfast. I start work at 6:00 a.m. and typically work to 4:30 p.m. each day. I meditate twice a day for about twenty minutes, which I learned is healthy for our brains and can prevent dementia [www.google.com/webhp?sourceid=chrome-instant&ion=1&espv=2&ie=UTF-8#q=dementia%20mindfulness%20meditation].

Rod: How do you stay technically current with changes in the profession?

Michael: I am one of the regulars (typically about ten months out of the year) on NACVA's "Around the Valuation World." That forces me to stay current on the information sources I'm responsible for. I also read the *ABA Journal*, the ASA's *Business Valuation Review*, NACVA's *The Value Examiner* and *QuickRead*, and BVR's *Business Valuation Update*. I attend at least two technical conferences a year and, with my forty to fifty speaking engagements, get a lot of CPE listening to my peers.

Rod: What business, but non-BV, book have you most recently read or do you want to get to and why?

Michael: Chris Mercer's book, *Unlocking Private Company Wealth*. I think with so many baby boomers retiring and so many new parties taking over entities, both groups need help… but don't necessarily know they need help until you explain it

to them. I see this as one of the major growth areas for those that want to expand and diversify their firms.

Rod: What's your work-life balance like?

Michael: I have tracked my hours in a spreadsheet every week since I started my business. In November 2013, I had eight mediations, gave five presentations around the country, and serviced six clients. I worked eighty hours a week for four weeks. That was enough of that. Today, I average forty-five to fifty hours per week, which includes some thirty-five-hour weeks (with holidays) and some sixty to sixty-five hour weeks (with speaking engagements and travel).

I have found this quantity of work provides a good work-life balance given that I see my fifteen-month-old granddaughter twice a week, babysit her with my wife once a week for most of a day, eat right, exercise, meditate twice a day, volunteer in various venues at least once a week, and participate weekly with my faith tradition. Somehow, it all works for me.

I encourage everyone to explore the Mayo Clinic web page [http://www.mayoclinic.org/] for nutrition and exercise information, even though most of us know what we should eat and how much we should exercise. However, most people are ignorant on how to exercise their brain. So, I also encourage everyone to consider doing some basic research on neuroscience and to check out the Greater Good [http://greatergood.berkeley.edu/] from the University of California at Berkeley. They have some great ideas.

Rod: What practice areas do you think offer the most promise to someone going solo now?

Michael: In my presentations on "How to Work with the IRS," I highlight data indicating that the number of gift and estate tax filings has actually gone up since Congress enacted the higher filing thresholds. I see this tax valuation work, divorce valuation work, intellectual property valuation work (especially related to transfer pricing issues), and damages work as growing fields nationally. Beyond those observations, I would advise my valuation compatriots to know your skill level and enhance those skills. Know your market and who you can count on for clients that will want and pay for your services.

Rod: Finish this sentence: If I knew then what I know now, I would…

Michael: …not have been as worried as I was or have had as much apprehension as I did. I am very blessed in so many ways with my family, friends, and professional associates that, with my education, experience, knowledge, and passion to serve, I believe I was set up for success from the beginning. If you have a passion for what you do, you never have to work a day in your life. VE

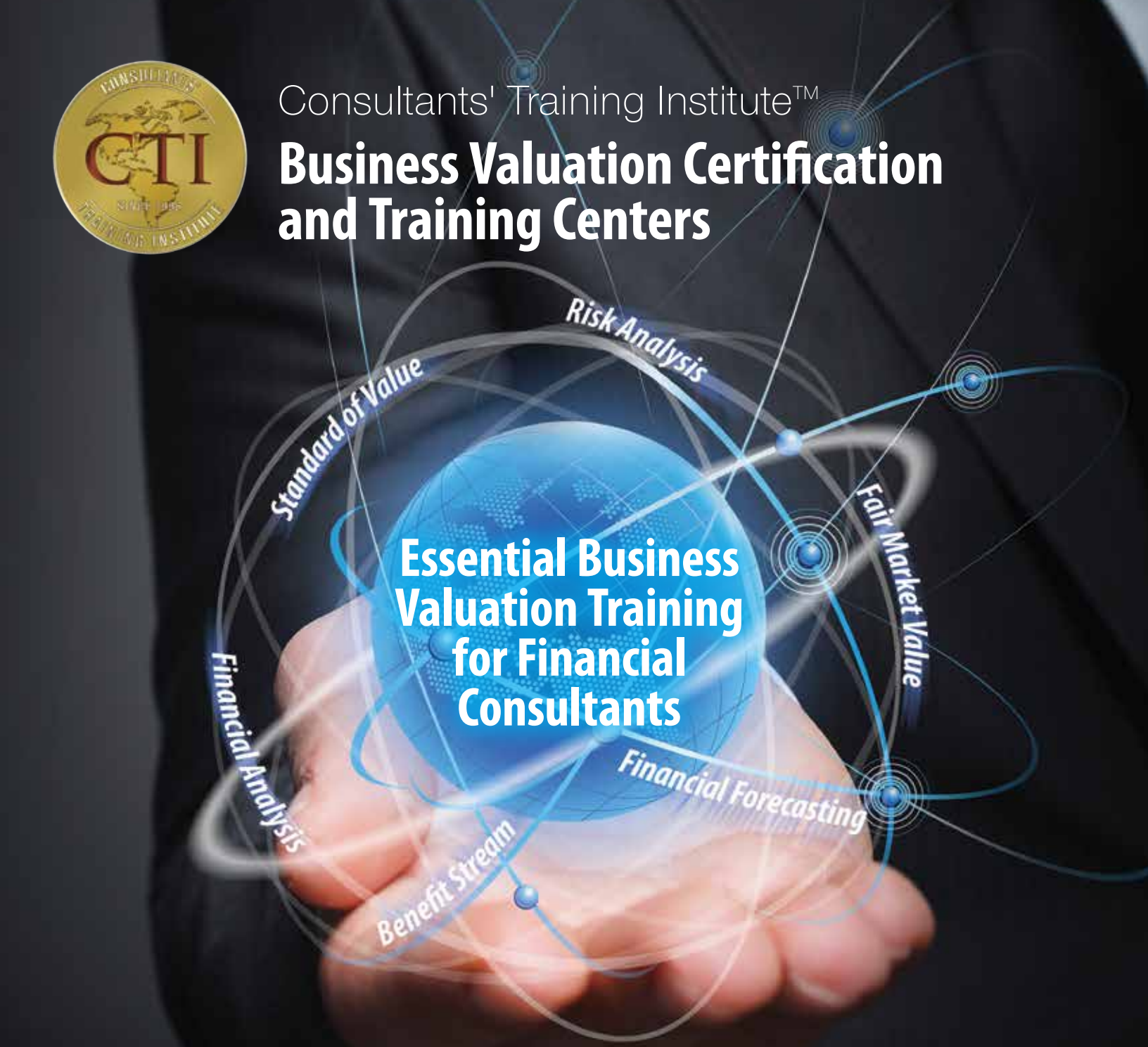
That's a wrap! Do you have a Practicing Solo issue you would like me to address? E-mail me at rod@practicebuilderacademy.com. Looking for advice on how to build your practice? Post your question on Practice Builder Academy TV at www.AskPBA.com.



Rod P. Burkert, CPA, ABV, CVA, is President of Burkert Valuation Advisors, LLC (rodburkert.com). His engagements focus on income/gift/estate situations and working with successful business owners who are looking to make a transition. He also provides independent report review and project consulting services to assist fellow practitioners with their assignments. Rod is also the co-founder of Practice Builder Academy (practicebuilderacademy.com), a twelve-month mentoring program that teaches proven strategies to BVFLS professionals who want to build their practices and redesign their lives.

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PRACTICE MANAGEMENT

Practitioner Roundtable: THE JOURNEY TO A VIBRANT PRACTICE

Moderator: Nancy McCarthy, Senior Editor, The Value Examiner

Recently, *The Value Examiner,* had the opportunity to speak to four professionals presenting at the NACVA and CTI's Annual Consultant's Conference held June 8-11 for in the Business Applications, Communication and Practice Management Track on Saturday, June 11. These roundtable participants have very different backgrounds and each brings a unique perspective both to their presentations and to the profession. The participants are:

Marty Abo, CPA, ABV, CVA, CFF (*The Engagement Letter—It All Starts Here (And Could End Here),* has comprehensive experience in individual and corporate financial, business and tax planning. His previous experience includes several years with the tax department and audit staff of a Big Four CPA firm as well as regional firms before he founded Abo and Company, LLC and Abo Cipolla Financial Forensics, LLC. He is a graduate of Syracuse University.

Rod Burkert, CPA, ABV, CVA, CVB (*Practice Builder Immersive Lab—Concepts to Concrete: 3 Tactics That Will Move the Needle on Your Practice Further and Faster)* founded Burkert Valuation Advisors in 2001 and co-founded (along with Mel Abraham) Practice Builder Academy in 2013 to teach colleagues the positioning skills they need to grow their practices. Rod is an instructor for NACVA/CTI's Consultants Training Institute, and a regular contributing author to *Business Valuation Update, The Value Examiner*, and *Financial Valuation* and *Litigation Experience*.

John DeRemigis, senior editor, QuickRead (*Writing for Publication: A Short Guide to Help You Become a Noted Commentator).* He specializes in developing high value content and content-enabled solutions for professional audiences in accounting, finance, and management, including test prep and certification, books, e-books, and e-learning. His extensive experience in publishing includes stints as executive editor with John Wiley and Sons; senior acquisitions editor at Houghton Mifflin Harcourt; and product development manager at AICPA. John holds a BA from Villanova University.

P. Dermot O'Neill, CPA, ABV, CVA, CFF, MAFF (*Writing for Publication: A Short Guide to Help You Become a Noted Commentator)* is the managing editor of National Litigation Consultants' Review. He has forty years' experience as a Certified Public Accountant. His practice is concentrated in forensic accounting, litigation support, business valuation, transaction consulting, financial analysis, and income taxation. He graduated from Villanova University with a BA in Economics.

VE: How did you get into this business?

Marty: I graduated from college, got a job with one of the Big Eight—later, Big Four—accounting firms. Eventually, I went to work for a regional firm, and later started my own firm. Overtime, I established some expertise by helping attorneys to strengthen their cases. I helped them to clarifying their language and economic concepts. I also assisted them in preparing useful exhibits and reports, and testifying as an expert witness.

Dermot: When I was in high school, I took an aptitude test that gave me ninety-eight percent in engineering and ninety-eight percent in accounting. So, when I got to college, I started in engineering. I then transferred to business school in my junior year and got involved in accounting. Basically, I got started doing systems design and development, and got a lot of good analytical experience. By 1980 or so, I realized my clients were more interested in taxation issues.

I became a senior tax manager working with labor unions. Got into ERISA; got into real estate. I started studying business valuation. I have been doing litigation and valuation work with

my tax background since the '90s. My current firm is involved with valuation, damage measurement, IRS appeals, etc. It is very similar to what Marty does.

Rod: Dermot and I are brothers from another mother; I was pre-med. Depending on who you talk to, I thought my parents wanted me to be a doctor. Somewhere in my sophomore year, I met the evil witch called organic chemistry. I earned a "C," which is respectable in some study areas, but is a death knell in pre-med. I had this idea I had to graduate in four years. So, I decided to go into economics and accounting. I went to summer school and got to graduate on time. That was it. I had no real plan and I received no signs. I am incredibly lucky. Still have no freaking idea how it all worked out.

John: Well, keeping with the theme of "I prepared for a different, yet undefined career," I was an English major. Then, as now, the question was, how does that help you get a job? So, my first job out of college was selling text books. Eventually, that led me to a job where I got to edit the books, so I guess the liberal arts background came in handy. Eventually, I went to work for AICPA and learned about business valuation. I was there for a few years before I went to J. Wiley and Sons. While I was there, I helped them develop the GAAP program and met Shannon Pratt. I was there for almost eighteen years before I retired and started my new career in consulting and as the senior editor for NACVA's *QuickRead.*

VE: How would you describe what you do now?

Marty: I have developed some specific expertise over the years: I provide litigation support in the banking, insurance, and even the legal community. That means I provide technical assistance, arbitration, or expert testimony. Truthfully, I have the most difficulty describing litigation support: I prefer to call it "dispute resolution." Certain actions in business—or even in life—fall under the heading of "preventive medicine." Like recommending steps to a business owner to take before the business fails, or giving couples advice that prevents the divorce before it happens. But, disagreements do take hold. So, I would say I facilitate planning in the event the worst happens.

Dermot: After many years with various firms, I am now a consultant, teacher, and editor. I provide consulting and expert witness testimony in cases involving bankruptcy, accountant's liability, shareholder disputes, personal injury, wrongful death, as well as contract and tort damage issues measured by lost profits and/or diminished business value. I have testified as an expert in Pennsylvania, New Jersey, Delaware, Florida, New York, and Virginia as well as Delaware Chancery Court, Federal Bankruptcy Court, and Federal District Court. I also teach graduate school courses at Rider University in New Jersey. And, of course, I am the managing editor of *National Litigation Consultants' Review.*

John: I work with BV professionals to help them establish their communication platform; I am sort of an editor-at-large in terms of finding potential topics and writers for my former employer, J. Wiley and Sons, and I am the senior editor of *QuickRead.*

Rod: Well, as most people know, I live and work out of my RV. My wife Amy—who is also a CPA—and I made the decision to have a certain work/life balance. So, we sold our home in Pennsylvania and I have been running my business valuation practice—which focuses on management succession planning, gift and estate tax planning, and related litigation support—from the road.

I co-founded Practice Builder Academy in 2013 with Mel Abraham to teach colleagues the positioning skills they need to grow their practices. I am also an instructor for NACVA's Consultants Training Institute, which develops and presents professional education courses on business valuation and related practice areas. I am a regular contributing author to *Business Valuation Update, The Value Examiner, and Financial Valuation and Litigation Expert.*

VE: What is some practical advice you would give someone starting out in the profession?

Marty: I think it is good to work in the "real world," but build bridges to the academic world, too. You need to develop a skill set—build in some hard core practical experience. But keep taking courses and classes, too. There is such a body of knowledge out there. Knowing the cost of capital makes more sense if you have read about it and have experience analyzing it. You also want to make sure you like this world of business valuation. The earlier you find out what you like, the better off you are. And remember, you learn from mistakes. Which makes me very smart, I think.

Dermot: Marty is right. Coming directly into financial forensics right out of college or graduate school is probably an error. What Marty and I do would not be possible without a substantive background. Even grad students do not have an adequate feel for business forensics. You can't just look up an answer. You need to get some experience in auditing or tax planning. You can't just study analytics, you need to experience how analytics factor into valuations.

John: I am definitely biased in this area, but I think you need to develop your communication skills. This business is ultimately about people and their livelihood. You want to be able to explain to them what it is that you are doing and why. I also think that you want to establish yourself as a subject matter expert…

Marty: Especially when you are at that point when you have become one! A lot of people going into this business are saying "I am going to do this specific thing." But, most of us in the business sort of evolved into it. The accountants always had the boots on the ground. We generally knew what was happening on a day-to-day basis. When the disputes came up, we were able to work our way through it; we applied what we knew—we did not have formal academic training as a forensic specialist. We applied our skill sets and basically "became" those specialists.

John: Right! So you do want to develop your writing and communication skills.

Rod: As an employer, I generally prefer candidates with some liberal arts in their background. I always want to hire individuals who have good people skills. I can teach someone how to be a better business valuator; it is a lot harder to teach someone how to deal with people. I also value good writing skills.

Dermot: Writing skills are really important. Somehow, that liberal arts component in an accounting major is almost non-existent these days. Quant over comes all. I teach graduate school and I see the results of not giving students a better foundation in communication. Often, the writing is atrocious. I have my students write a business evaluation as a final project, which can be perilous for many students.

VE: What changes in business practices surprise you the most?

John: I think the way in which we communicate now has a whopping impact on everything we do, including how we value business. The internet, social media, and other tools are resources that were unheard of twenty years ago. As an editor and former publisher, it is alarming how the idea of a physical book is almost becoming obsolete.

Marty: I agree that technology is changing almost everything. Twenty-five years ago when I would go to Washington, DC, I would steal a phone book. Why? Because, I knew if there was a National Association of anything, it was located in DC. If I was doing a proposal to get new business, I would get that info. Now it is a flick of the switch, and there are the solutions and resources. That is one advantage younger people have over us older folk: the experience and ease in connecting the dots. The information explosion has changed everything

Dermot: Old tools are still good, though. Back in the early '80s, we were able to use Lexus/Nexus. I still find Boolean data to be a great tool to bring up in lectures and presentations

Rod: For me, it is the ability to look for and refine tools that can help us value all kinds of businesses. That is more possible now than in the past because of the availability of information and the tools that can help us access that information. For example, we still continue to apply large company valuation procedures to small businesses. Small businesses are the core of all business. Much of what we read is not applicable to companies with revenue less than $10 million. So, I think moving to ways in which we can value the two types of businesses based on different procedures is a step in the right direction.

VE: Is there a downside to this information explosion?

John: Yes, you can't always trust the source material on line. You cannot, for example, simply rely on something like Wikipedia. In some ways, you have to work a bit harder to find trusted source material.

Marty: That's right. Anyone can put anything out there. True story: I was part of a trial where the opposing expert witness is on the stand and he is rattling off all sorts of data that caught me off guard. So, the attorney asks, "Where is this information coming from." The guy says, with great confidence, "From the internet." I had an image of little Joey out in Seattle somewhere, sitting in his bed room and writing something on Facebook. And this guy is quoting it.

Dermot: You have to be sure you are working with authoritative publications. And, you really need to know your sources. Some things we say are not authoritative: opinion, perhaps, but not certain fact. You have got to know what is authoritative.

Rod: Wasn't there an old TV show where one of the characters said, "Just give me the facts, ma'am"? But that's true. We are all entitled to our opinions, but not our facts. I agree that there is a challenge in terms of separating the two when researching on the internet.

VE: How do you hope your presentation will help practitioners?

Marty: To me, it all begins and ends with the engagement letter (EL). Very few of us are in this business solely for the fun. We are in it to make money, it is a business, and we are here to help. The EL ties in to everything. This isn't gene splitting science. I am taking everything I've learned and putting it together for the client or, sometimes even the court. It gets very practical and not one size fits all. The communication

piece is so key. It lays out what we are going to do or not do; lays out everyone's responsibility.

Dermot: We (John, Nancy, and I) are doing a panel (at Conference) on how to make writing part of your practice. My segment is to give some ideas on how you make the time in your practice to write. Writing is really a big part of the marketing plan and that it is part of an ongoing plan. Writing is another way to establish yourself as an acknowledge expert. One of the illustrations I use is that all the stars of this profession started as regular practitioners.

John: My segment is to help you learn about the steps in publishing a book. I discuss how you can build a platform and what you should write. Then, I tell you the various ways to get published.

Rod: Mel and I, along with two guest speakers, are conducting a lab. We are showing practitioners how to use video. We are binging in someone who has used video to enhance their practice. As a lab, we will set up a camera, and help participants set up their own video. There will be a very concrete take-away.

VE: The theme of the conference is "Strong Foundations Build Bright Futures." What is the one thing you would tell someone starting out that they absolutely must consider?

Rod: Eventually, you start out as a generalist and then you specialize. Back in the day, you could be jack of all trades. Whether you specialize by a practice area or niche, you need to mine that knowledge to show expertise.

John: Right, you have to build a platform

Dermot: Yes, but it is important that each practitioner look at themselves to figure out what is best for them. My advice is to not follow something that might be "hot" at the moment. Don't follow rules, take the time to look inside and figure out what is "hot" for you.

Marty: I am not disagreeing, but there are two sides to the coin. There are people who are older and who have been in the business a long time: they may not become a specialist. I have a lot of experience in this business and I know what I don't know. Meaning, I may not be the expert, but I know who to bring in. I will bring someone in who may be stronger on the stand: There is always someone who knows more than you.

Dermot: Our generation is beginning to decrease. There needs to be some definition of a direction within the profession. My business is based on adversarial relationships. People coming up now, have a bit narrower education.

Marty: It's a fast moving world. It is no different in our profession. Banking used to be pretty straight forward; you had a business banker or an individual banker. Today, you have a dozen different types of bankers to handle another dozen aspects of your business. Too many specialties and analysis can be dangerous.

VE: How do you follow your own advice?

Marty: Who remembers Groucho Marx? I like his advice: I'd never join a club that would have me as a member. But seriously, I make a point to learn from my own mistakes. I enjoy it more when I learn from others mistakes, but I am humbled when I learn from my own. It is inevitable that you are going to make mistakes, so it is best to own up to them immediately and understand that you can't have success without a failure or two.

Dermot: In my case, I do know what I don't know, so I know to refer some things to other professionals. Not only do I get a better result, I strengthen my network and professional relationships.

John: I tend to make a decision and stick with it. Unless it was a very bad decision to begin with, of course. Then I try to "course correct." Even making a poor decision is way better than making no decision. Not making a decision takes the power out of your hands.

Rod: I have discovered my niche and I do well within its parameters. My niche is manufacturing and distribution companies with than $15 million in assets. I try to stick to my knitting. I learn the segment I do work with very, very well.

VE: Well, as Rod would say, that is a wrap, folks. I would like to thank all of you for taking the time to share your insights with *The Value Examiner.* I am looking forward to seeing everyone in San Diego, and I look forward to seeing as many presentations as possible. VE



Nancy McCarthy, Senior Editor, The Value Examiner, has over twenty-five years experience in the financial services field. She has worked at Merrill Lynch, Prudential Securities, Rydex Funds, and Nationwide Insurance as a marketing and communications specialist and, occasionally, vice president. She holds a BA in journalism from Pace University and an MA in Communications from New York Institute of Technology. E-mail: NancyM1@nacva.com

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