# Financial Valuation *and* Litigation Expert

VIEWS AND TOOLS FROM LEADING EXPERTS ON VALUATION, FORENSIC/FRAUD AND LITIGATION SERVICES

## Editor's Outlook

Jim Hitchner
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Greetings! Our front page article this month is both concise and practical. We take a look at how judgement, experience and "common sense" still factor into most valuations— basic but important stuff!

Kevin Yeanoplos joins us as a panel member with a great article where he spells out benchmarks for cost of capital. He explains how public company data can be applied in valuing small businesses.

As in our front page article, Mark Lee and Adrian Campelo again address the issue of professional judgement— this time in adjusting market multiples. The authors go through the various mathematical models and show how there is still a reliance upon professional judgement in the final analysis.

Next Rod Burkert takes us away from all of the technical issues as he details concrete ways to increase one's personal productivity. Rod interviewed our panel members and others in the field to come up with a consensus of "best practices."

Another author new to *FVLE* is Derald Lyons, who examines the effect of the global economic meltdown on the guideline company transaction method.

*Continued on next page*

# Common Sense Issues in Weighting Values

We all hear that valuation is an art as well as a science. That's still true, but to a lesser degree than it was several years ago. Valuation analysts have much more information and data available to them now than ever before. However, judgement, experience and the often ignored "common sense" are still a major part of any valuation. Presentation counts too. Below are some common sense issues that analysts sometimes fail to recognize when concluding to a value conclusion by weighting value indications by different methods.

### 1) WEIGHTING OF TWO VALUES

Let's start with when you have two indications of value, say one from the capitalized cash flow (CCF) method of \$5.0 million and one from the guideline company transaction method (GCTM) of \$3.8 million. Let's also ignore discounts for the time being and assume both values are on the same level of value. If you average the two indications of value, the conclusion is \$4.4 million, with a 50 percent weight to each value. Now, let's assume the analyst decides not to use numerical weights but uses the acceptable method of qualitative weights. For example, the analyst may say he or she believes the CCF method has better support than the GCTM and chooses \$4.8 million without any numerical weights.

Even though the analyst says he or she did not use numerical weights, there is an implicit— maybe even an explicit— weight that is easily calculated. With only two indications of value, you can easily back into weights using the simple algebraic formula:

VC = PWM1(M1 Value) + (PWM2)(M2 Value),
*Where:*
VC = Valuation Conclusion,
PWM1 = Percentage Weight for Method 1
PWM2 = Percentage Weight for Method 2 and
PWM2 = (1 – PMW1)
M1 = Method 1
M2 = Method 2

*Continued on page three*

## EXPERTS in this Issue

# Financial Valuation and Litigation Expert

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## EDITOR'S OUTLOOK, continued

Next up, Stacey Udell, also a premiere columnist, delivers a comprehensive report on reasonable compensation. Stacey first examines the *Menard* case and its subsequent reversal. She outlines several methods for assessing compensation and brings readers a variety of resources to help in determining reasonable compensation. She also lists court cases involved with that topic.

Rounding out this issue, Tom Hilton discusses both the history and future regarding the discoverability of draft reports.


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Using our example:

4.8 = (PWM1)(5.0) + (1-PWM1)(3.8)
4.8 = 5.0PWM1 + 3.8 – 3.8PWM1
4.8 = 1.2PWM1 + 3.8
1.0 = 1.2PWM1
PWM1 = .8333
PWM1 = 83% rounded
PWM2 = 100% - 83% = 17%

The derived weights are 83 percent to the CCF method and 17 percent to the GCTM. As you can see, a small difference in the concluded value ($4.4 million to $4.8 million) results in a weighting change of 50 percent/50 percent to 83 percent/17 percent. Also, a qualitative weighting method was just changed to a quantitative method by simple algebra and indicates very little weight to one of the methods. There is nothing wrong with qualitative weighting. It's done all the time. However, with only two value indications, which is not uncommon in smaller businesses, qualitative weights can be turned into quantitative weights. It's just common sense.

## 2) AVERAGING OR WEIGHTING VALUES

Let's take the above example and change it a bit. Let's add a third indication of value, say $2 million by the net asset method. Again, let's assume all values are on the same level of value for this example only. Our values are as follows:

| | |
|---|---|
| CCF Method | $5.0 million |
| GCTM | $3.8 million |
| Net Asset Method | $2.0 million |

The mean average is $3.6 million [(5.0 + 3.8 + 2.0)/3]. Does this sound reasonable? Let's break this apart some. The CCF value of $5.0 million is 39 percent higher than the average of $3.6 million, 32 percent higher than the GCTM value of $3.8 million and 150 percent higher than the NAV value of $2.0 million. Let's assume that the analyst here believes that the CCF method is the best method and that the GCTM is better than the NAV method. The pecking order is CCF method, GCTM and the NAV method. Great, now what do we do? Here are the choices:

- Use a mean average of $3.6 million
- Use a median average of $3.8 million
- Use numerical weights
- Throw one or more value indications out
- Use qualitative weighting
- Forget about it and go fishing

Using a straight mean average means each method has equal weight, 33.3 percent each. How can a $2 million value have equal weight to a $5.0 million value? The median is not much better here, as it may appear that the analyst is putting all the weight on the GCTM value. This is not the case, but it does appear so.

If we use numerical weights, where do they come from? Well, they come from professional judgment. That's fine, but let's continue our example. The analyst applies weights as follows, again with the assumption that the CCF method is the best method and the GCTM is better than the NAV method.

| | | |
|---|---|---|
| CCF Method | $5.0 million | 70% |
| GCTM | $3.8 million | 20% |
| NAV Method | $2.0 million | 10% |

This results in a value of $4.5 million. Is this a better value conclusion than an averaging technique? Probably yes. However, there could be criticism about the credibility of relying on a method with only a 10 percent weight. The CCF value has a weight seven times as great as the NAV value.

Many analysts would probably throw the NAV value of $2.0 million out (with support), as it is so much less than the other two values. Let's assume we do that. Here is another look at numerical weights:

| | | |
|---|---|---|
| CCF Method | $5.0 million | 80% |
| GCTM | $3.8 million | 20% |

The value conclusion is now $4.8 million, probably closer to the actual value. However, even here the CCF value weight is four times the GCTM weight, not as bad as seven times the NAV weight in the previous example, but still a factor to consider.

Qualitative weights can also be used when you have the three indications of value presented previously. Again, let's assume that the analyst here believes that the CCF method is the best method and that the GCTM is better than the NAV method. The analyst may just say this and select, say $4.8 million. The analyst may also throw out the NAV value and use qualitative weights, but then you are back to the issue presented in number 1 "Weighting of Two Values" on page one.

Well, the heck with all this. It's just common sense. We're going fishing.

# General Benchmarks Help Determine Cost of Capital

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I had a discussion with a valuation professional the other day that I swear I've had one hundred times before. It went something like this: "How can you determine the value of a small, closely held business by looking at a bunch of much larger publicly traded companies? The public companies are so much larger than the private company that it just makes *no* sense."

Of course, the same valuation professional has no qualms about using the data from Ibbotson, Duff & Phelps, or some other resource to derive an equity risk premium, even though the publications derive their data from the very same general source that was so easily discarded earlier.

We'll save the discussion of this inconsistency for a future article. Instead, we will attempt to answer a similar question, namely: Is it relevant to use cost of capital data from the public market to value small, privately held companies? The short answer is not just *yes*, but *heck, yes*!

We business valuation professionals seem to forget that the historical roots of business valuation theory stem from real estate appraisal theory, which has always been about reference points. Simply put, if we know what a three bedroom house on the next block sold for last week, it seems reasonable that by using the "comp" as a reference point, we can determine the value of a two bedroom house on this street.

Perhaps it's an oversimplification, but when we value a small business, aren't we just comparing it to a "bigger house"? Such a comparison results in the differences (among others) between "small houses" and "big houses" listed below.

By recognizing the existence of these key differences and others we can adjust for them in the valuation. Obviously, most of these differences make the small business investment a riskier proposition than a similar investment in a big company.

It is important then to remember a few additional reference points, namely, what we call in our shop the "investment spectrum." As indicated in the chart on the next page, the spectrum lists equity returns for investments at different risk levels.

By initially comparing our small company to the different "houses" listed in the chart on the next page, we can generally conclude that an appropriate return on our "house" would fall between small cap publicly traded stocks and venture capital investments. While there may be small companies that should fall outside of this range, they would be rare. Although analysis is required to determine where our company falls in the spectrum we can at least be confident that it falls within a reasonable range.

*Continued on next page*

| LARGER BUSINESSES | SMALLER BUSINESSES |
|---|---|
| Revenues generally over $50 million | Revenues generally under $5 million |
| Some outside owners | Inside owners |
| Typically C corporation | Typically S corporation, proprietorship partnership |
| Non-owner management | Owner-family member management |
| Entity and operations entirely separate | Entity and operations inseparable from the owner(s) |
| Company expected to survive current owner(s) | Company may not survive current owner(s) |
| Company operates as a business institution | Company operates more as an association of individuals/ practitioners |
| Often more than one location | Generally, one location |

*expert* **TIP**

**Cost of capital data from the public market can be used to value small, privately held companies.**

It may seem somewhat heretical to suggest that we should determine a range of equity returns for our small company prior to performing an in-depth risk analysis. However, experience tells us that the vast majority of the small companies that we value do, in fact, fall within the range we suggest.

Whether we use Ibbotson, Duff & Phelps, or some other data source for our discount rate build up, it provides us with a meaningful starting reference point. By using the data, we are able to "maximize objectivity" through the use of empirical information. However, we still maintain the ability to use our judgment, whether through a summation method, total beta method (promoted by Butler Pinkerton), or some other method, to determine the subjective company specific risk premium.

In conclusion, it makes complete sense to use the same data sources to value small businesses that we use for large businesses. We must simply remember the reference points within the investment spectrum and determine where our "house" falls in the spectrum.

## Investment Spectrum Annual Rates of Return
## Development of Discount Rate

| Investment Type | Annual Return |
|---|---|
| Long-term (20 yr. maturity) Treasury Coupon Yield[1] | 3.98% |
| Long-term Corporate Bonds Arithmetic Mean Return[2] | 6.2% |
| Largest Decile Arithmetic Mean Return[3] | 10.8% |
| Real Estate Investment Trusts (REITs)[4] | 13.8% |
| Smallest Decile Arithmetic Mean Return[5] | 20.1% |
| Venture Capital - Second Strage/Expansion[6] | 20%-40% |
| Venture Capital - First Stage/Early Development[6] | 40%-60% |
| Venture Capital - Start Up[6] | 50% - 100% |

1 Federal Reserve Statistical Release dated March 2, 2009
2 Reflects the mean return for long-term corporate bonds from 1926 through 2008 reported by *Stocks, Bonds & Inflation, 2009 Yearbook*, published by Morningstar
3 Reflects the mean return for the largest decile portfolio (market capitalization of higher than $18.5 billion) from 1926 through 2008 reported by *Stocks, Bonds & Inflation, 2009 Yearbook*, published by Morningstar
4 Reflects the compound annual return of REITs from 1975 to 2005 reported by the National Association of Real Estate Trusts
5 Reflects the mean return for the smallest decile portfolio (market capitalization between $1.6 million and $218.5 million) from 1926 through 2008 reported by *Stocks, Bonds & Inflation, 2009 Yearbook*, published by Morningstar
6 Timmons, Jeffrey A. *A New Venture Creation*, 5th edition, (Chicago: Irwin, 1999).

# Adjusting Market Multiples:
## The Final Decision is Still a Matter of Professional Judgement

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### INTRODUCTION

Judges and auditors would like to have a mathematical business valuation method that is widely recognized, standardized, accurate and completely objective. This method would make it much easier for them to decide among the divergent valuation opinions and to test appraised values assigned to financial assets. One mathematical method that is being advanced is the fundamental discount. It uses predetermined formulas to compute market multiples for a private company's common equity given the firm's size and earnings growth in comparison to those of selected public companies. However, this method has serious potential concerns and still depends on the use of professional judgement.

### TESTED VALUATION METHODS IN THE MARKET APPROACH

In the market approach, the appraiser determines the value of common stock by developing pricing analogies as of a specific date. The practitioner first determines how various financial and business characteristics of publicly traded companies affect their market multiples and then selects appropriate multiples to apply to the subject company's characteristics to determine the value of the firm's common equity as of the same date.

Financial analysts have known for many years — through trial and error — that public companies' EBITDA multiples tend to be correlated to their EBITDA margins. Public companies' price to book value multiples tend to be correlated to their returns on common equity, and price to earnings multiples tend be correlated to expected growth.[1]

However, these observed correlations are far from perfect. They may not exist for a specific industry as of a specific point in time due to either subjective factors, such as the quality of the company's products and management, or objective financial factors, such as leverage, the existence of non-operating assets or the inter-relationships of the pricing variables themselves. For example, a corporation's common stock may appear to have a high price-to-earnings ratio, but it might be due to the stock's low price-to-book value ratio or high dividend yield.

Clearly, using these standard pricing mechanisms requires the valuation practitioner to determine if these correlations exist as of the valuation date, to apply professional judgement to determine the appropriate earnings growth rates and to sort out the impact of various other factors in determining the price for a company's common equity.

### THE FUNDAMENTAL DISCOUNT METHOD

The fundamental discount method determines market multiples for a subject company by mathematically adjusting guideline company multiples for differences in risk and earnings growth rates using predetermined formulas.

The method was described in detail in a September 1998 article.[2] According to the author, differences in earnings capitalization rates (that is, the inverse of the price-to-earnings ratio) are dependent upon differences in risk attributes and earnings growth rates. These two factors cause the differences between public guideline companies' price-to-earnings multiples and those of a subject business. The relationship among risk, growth, capitalization rates and the fundamental discount, according to the author, is shown in the following equation and its transformation:

(Eq. 1) $FD = 1 - [(P/E)_{subject}/(P/E)_{guideline}]$

*Where:*
P = Price
E = Earnings
FD = Fundamental Discount on guideline P/E
Guideline = Public guideline company or median of public guideline companies
Subject = Company being valued

The fundamental discount is simply one minus the ratio of the subject company's price-to-earnings ratio divided by the guideline company's price-to-earnings ratio.

Inverting Equation 1 produces the following equation:

(Eq. 2) $FD = 1 - [(E/P)guideline/(E/P)subject]$

As the inverse of the price-to-earnings ratio is by definition the earnings capitalization rate, the fundamental discount is one minus the ratio of the earnings capitalization rate of the guideline company divided by the

*Continued on next page*

**expert TIP**

**Mathematical models and formulas to determine fundamental discounts to public company multiples still require professional judgement.**

earnings capitalization rate of the subject company.

The author next adapts from the "steady-state" perpetuity capitalization model the following equation:

(Eq. 3) Capitalization Rate = $(k_x - g)$

*Where:*
$k_x$ = Investors' required rate of return or discount rate on earnings[3]
g = Estimated annual growth in future earnings

He then substitutes the capitalization rate from Equation 3 for the capitalization rate into Equation 2 to derive Equation 4:

(Eq. 4) $FD = 1 - [(k_x - g)_{guideline}/(k_x - g)_{subject}]$

According to the author, differences in risk and future earnings growth are the primary drivers influencing the magnitude of the fundamental discount. Thus, the price-to-earnings ratio of the subject company can be calculated by adding premiums for risk and growth to the earnings capitalization rate of each guideline company (or the median of the guideline companies) to determine the price-to-earnings multiple of the subject company as shown in the following equation:

(Eq. 5) $P/E_{subject} = 1/(\text{Cap. Rate}_{guideline} + \triangle_{risk\ premium} + \triangle_{growth})$

*Where:*
$\text{Cap. Rate}_{guideline} = 1/(P/E)_{guideline}$ or $k_x - g$
Risk differential $\triangle_{risk\ premium} = k_{x\ subject} - k_{x\ guideline}$
Growth differential $\triangle_{growth} = g_{guideline} - g_{subject}$[4]

Based on the author's analysis, the current method for adjusting a guideline company's price-to-earnings multiple for growth is shown in the following equation:

(Eq. 6) $P/E_{subject\ growth\ adjusted} = 1/(\text{Cap. Rate}_{guideline} + g_{guideline} - g_{subject})$

*Where:*
g = Blend of short-term and long-term growth rates

The short-term growth rate for the guideline company is based upon analysts' earnings forecasts for the first three to five years. The long-term growth rate is based upon the long-term growth rate for the United States economy.

The current method for adjusting a guideline company's price-to-earnings multiple for risk analysis is shown in the following equation:

(Eq. 7) $P/E_{subject\ size\ adjusted} = 1/(\text{Cap. Rate}_{guideline} + s_{subject} - s_{guideline})$

*Where:*
s = Size premium from SBBI or Grabowski/King studies

While the 1998 article considered all factors affecting risk, the current practice is to focus on the most measurable risk factor — the firm's size.

## CAUSES FOR CONCERNS IN USING THE FUNDAMENTAL DISCOUNT

Unlike standard pricing multiple analyses, the fundamental discount is not a valuation technique that has been tested for many years by buyers and sellers in the marketplace. Practitioners and their clients should be aware that there are several potential concerns in the method's implicit assumptions and that the method requires the application of professional judgement to achieve its results.

### *Assumption #1 – Only Size and Growth Materially Affect P/E Ratios*

The premise of the fundamental discount method is that a company's price-to-earnings multiple at any given valuation date is determined by two fixed linear equations with the firm's size and earnings growth rates as the only independent variables. While these types of equations might be valid on average over time, they might not be true on any given valuation date. Just as in the case of traditional correlation methods, the equations must be tested at any given point in time to ensure that the two factors as employed in the model largely explain the differences in guideline companies' price-to-earnings ratios.

### *Assumption #2 – The One-for-One Growth Adjustment to the Capitalization Rate*

In the fundamental discount model, a change in the growth rate is assumed to have an equal but inverse change in the earnings capitalization rate. This may not be true.

According to valuation theory, a company in "steady-state" has: (1) a constant growth rate in revenue, earnings and dividends; (2) constant profit margins; (3) constant working capital, balance sheet and capital expenditure relationships to revenue; and (4) a constant common equity discount rate. In theory, the price of a share of common stock of a company in "steady-state" is:[5]

(Eq. 8) $P = [PO \times E_0 \times (1 + g_p)] / (k_e - g_p)$

*Where:*
P = Common stock price
PO = Payout ratio or current annual dividends, including common stock buybacks, as a percentage of earnings
$E_0$ = Earnings per share
$g_p$ = Expected constant annual growth rate in dividends
$k_e$ = Discount rate on dividends

The term $[PO \times E_0 \times (1 + g_p)]$ is the firm's expected dividends for the year following the valuation date. The term $(k_e - g_p)$ is the capitalization rate for these dividends. After dividing both sides by the following year's earnings $[E_1$ or $E_0 \times (1 + g_p)]$, the price-to-earnings ratio can be expressed as follows:

(Eq. 9) $P/E_1 = PO/(k_e - g_p)$

The inverse of Equation 9 is:

(Eq. 10) $E_1/P = (k_e - g_p)/PO$

As $E_1/P$ is the earnings capitalization rate, then from Equation 5 the following equation can be derived:

(Eq. 11) Earnings Capitalization Rate = $(k_e - g_p)/PO = (k_x - g)$

As shown in Example 1 below, assuming the same growth rate in earnings and dividends and a 100 percent payout ratio, a change in the growth rate will have an equal inverse change in the capitalization rate.

(Example 1)

*Where:*
$g_p$ = 5% and 6%
$K_e$ = 12%
PO = 100%
*Results:*
($g_p$ = 5%) Earnings Cap. Ratio = 7% = (12% – 5%)/100%
($g_p$ = 6%) Earnings Cap. Ratio = 6% = (12% – 6%)/100%

However, as shown in Example 2 below, with a different payout ratio greater than zero, in theory, the change in the capitalization rate will be the inverse of the change in the growth rate divided by the dividend payout ratio.

(Example 2)

*Where:*
$g_p$ = 5% and 6%
$K_e$ = 12%
PO = 40%
*Results:*
($g_p$ = 5%) Earnings Cap. Ratio = 17.5% = (12% – 5%)/40%
($g_p$ = 6%) Earnings Cap. Ratio = 15% = (12% – 6%)/40%
$\triangle$Earnings Cap. Ratio = –2.5% = (5% – 6%)/40%

As the fundamental discount model assumes a change in the growth rate produces an equal but inverse change in the capitalization rate, in theory users of the model are implicitly assuming that both the guideline companies and the subject company can pay out 100 percent of their earnings in dividends forever without reinvesting any earnings in additional long-term assets or working capital. Clearly this one-for-one assumption must be verified as of the valuation date.

***Assumption #3 – Historical Size Adjustments Apply to Current Market Conditions***

The size premiums computed in the SBBI and Grabowski/King studies are calculated based on observations of the market prices of thousands of companies over several decades. Given the significant variability of the data, the historical average size premiums might not apply to a given set of guideline companies' common stock prices as of a specific valuation date. Therefore, the applicability of the historical size premiums also must also be verified.

(Eq. 12)

$$P/E = \frac{PO_{hg} \times (1 + g_{hg}) \times [1 - (1 + g)^n / (1 + k_{e,hg})^n}{k_{e,hg} - g_{hg}} + \frac{PO_p \times (1 + g_{hg})^n \times (1 + g_p)}{(k_{e,p} - g_p)\,(1 + k_{e,hg})^n}$$

*Where:*
n = the number of years in the high growth period
$PO_{hg}$ = the payout ratio in the high growth period
$g_{hg}$ = the annual dividend growth rate in the high growth period
$k_{e,hg}$ = the discount rate in the high growth period
$PO_p$ = the payout ratio in the stable growth period
$g_p$ = the annual dividend growth rate in the stable growth period
$k_{e,p}$ = the discount rate in the stable growth period

***Assumption #4 – The Long and Short-term Growth Rates Can be Blended***

If a company pays dividends or is expected to pay dividends but is expected to grow at a higher than normal rate for a number of years, the formula for the price-to-earnings ratio is shown in the box above.[6]

Adjusting the earnings capitalization rate for a difference in the long and short-term growth rates is far more complex then simply using a blend of these two rates. As shown in the formula above, in theory, a company's price-to-earnings ratio is a complex function of its projected growth and discount rates in the short and long-term growth periods, the expected length of the growth period and the expected payout ratio in each period.

## JUDGEMENT STILL REQUIRED

While applying the fundamental discount method may appear mechanical and objective, it still requires judgement. The valuation practitioner can choose among a wide variety of size and growth measures in calculating the price-to-earning ratio for a subject company's common equity. For example, the short-term growth rate can be measured by historical rates, projected rates, growth in revenues, operating income, earnings or dividends or a blend of any or all of these. The length of the short-term growth period also must be estimated. The long-term growth rates may focus on national or industry variables. The rate may be based on inflation or real growth or both. The impact of size can be measured in various ways as well. While SBBI only measures historical size premiums using common equity market value, it provides data to calculate premiums over different historical periods. The Grabowski/King studies use eight different size measures.

## CONCLUSION

Standard valuation methods in the market approach are market-tested techniques that require the analysis of the interrelationships of a number of financial variables as of a specific valuation date and the application of professional judgement. The fundamental discount method has the same requirements. Unfortunately, it has not been empirically tested, and its implicit assumptions create considerable concerns about its viability.

[1] See Pratt, Dr. Shannon, *Value a Business The Analysis and Appraisal of Closely Held Companies,* fifth edition, 2008, pp. 294-297. Damodaran, Dr. Aswath, *Investment Valuation Tools and Techniques for Determining the Value of Any Asset,* second edition, 2002, Chapters 18, 19 and 20.

[2] Goeldner II, Richard W., "Bridging the Gap Between Public and Private Market Multiples," *Business Valuation Review,* September 1998, p. 96.

[3] Goeldner used the symbol k.

[4] Goeldner II, Richard W., "Bridging the Gap Between Public and Private Market Multiples," *Business Valuation Review,* September 1998, p. 96.

[5] Damodaran, Dr. Aswath, *Investment Valuation Tools and Techniques for Determining the Value of Any Asset*, second edition, 2002, p. 471.

[6] Damodaran, Dr. Aswath, *Investment Valuation Tools and Techniques for Determining the Value of Any Asset*, second edition, 2002, p. 471.

# Increasing Your Personal Productivity

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*This article offers a break from fair value, distressed markets, cost of equity, and discounts for lack of marketability.*

*You're welcome!*

Seriously, I have often felt the need for a best practices forum to discuss how we do what we do. Have you ever wondered how your peers get their work done? Are there some tips that, if you only knew about (and implemented), would allow you to work smarter, not harder? Me, too! So, I surveyed FVLE's panel of experts and other valuation friends for their input. Whether you're part of a large firm or running your own shop, I've collected some useful tips. Here's the compilation.

### NICHE FOCUS

This was mentioned first and foremost because it could have the most profound impact on your productivity. Mastering a specialized practice area allows you to (i) distinguish yourself from generalists and (ii) command higher fees. It also minimizes non-billable time.

For example, if you take on many diverse engagements of businesses or securities that you know little about, there is a steeper learning curve, where you may or not get paid. What's the point if you are unlikely to see that same type of engagement again? You're better off referring the work to someone else and investing the learning curve time in marketing your area of expertise. And being a master might also mean that people seek you out to perform engagements instead of you prospecting for them.

### THREE MONITORS

This was the most frequent comment I received. Apparently, three is the new two, as many practitioners are now using three monitors: valuation report on one, valuation schedules on the second, and the Internet/Outlook on the third. One appraiser told me he was up to four monitors and sent me a picture of his desktop to prove it.

### DEVELOP TEMPLATES

Use templates for your various proposals, information requests, and reports instead of using the last one you completed. As applicable, templates incorporate all possible methods, scenarios, and language so you don't waste time sifting through past documents looking for how you did it the last time or just the right wording. You'll also avoid the embarrassment of presenting a document that did not purge all client references from the old file.

### AFFILIATE

This allows you to gain access to others for asking questions and vetting issues. This can be done formally, by joining groups such as the Financial Consulting Group (www.gofcg.org) or Economic Resource Connection, or informally, by developing a network of people you can call for help. I once did a presentation for a group of small practitioners who instituted monthly conference calls to promote collaboration.

### PRESCREEN REQUESTS FOR SERVICES

Send out a single-page checklist of items needed in advance of any meetings or proposals. This helps to weed out tire kickers and price shoppers by insisting that potential clients invest a small amount of time gathering the minimum detail needed to quantify the scope of the engagement. And how else are you going to get a look at the information you will be working with so that you can provide a reasonable fee quote?

### CAPITAL IQ

"It's expensive, but it's an amazing tool." Enough said.

### GET A MAC

A Mac is far more efficient and reliable than a PC; it can be accompanied by free NeoOffice software that opens and reads Word and Excel files and has a comprehensive suite of word processing, spreadsheet, and presentation programs. Yes, Macs are more expensive than PCs. But how much time have you lost with crashes, viruses, and blue screens of death (so common it is a Googlelable term). By the time you read this article, I will be typing on a MacBook Pro.

### TRAVELING LIBRARY

Develop a traveling library of scanned pages of your key reference sources (e.g., SBBI, Mergerstat) as well as PDF files of BV standards, glossaries, etc. This way, you have the information you need when you are working on projects while out of the office.

### BUY A CHAIR YOU CAN'T AFFORD

All sorts of research says you can be more productive if you sit in a chair that you can customize to your physical specs. Good chairs cost that much for a reason. Hint: anything you buy

*Continued on next page*

*expert* **TIP**

**Have you ever wondered how your peers get their work done? Here are some tips that will allow you to work smarter, not harder.**

from a big-box, office supply store probably does not qualify.

### BECOME AMBIDEXTROUS
Work the mouse with your left hand, the numeric key pad with your right. Saves a ton of time and wasted motion.

### NETBOOKS
The age of disposable computers has arrived. Unbelievable that you can buy these things for one to two hours of chargeable time. When you travel, what do you really need– internet/email access and the ability to do some work on a project. Put your data on a thumb drive and you're off. If the netbook is dropped, lost, or stolen – at least it's not your primary (only) laptop holding all of your data.

### THREE-RING BINDERS
Combine all of your various conference and CPE course materials for a like subject into its own three-ring binder. That way, you'll have all the information (which you thought was important enough to keep in the first place) on that topic in one place.

### NO MULTI-TASKING
To avoid multi-tasking, buy a timer. Start with a short time of say 15 or 20 minutes. Vow not to do anything but the task at hand for that time. Work up to 50 to 60 minutes. This is harder than you think, but you will soon realize the amount of lost chargeable time caused by flitting from one thing to another and back again.

### KEYWORD SEARCH TOOLS
Let the Internet work for you while you sleep. Use Filtrbox (www.filtrbox.com) or Google Alerts (www.google.com/alerts) to search for key words, e.g., "business valuation," "lost profits," whatever is relevant to your practice. You'll get a list of hits and text excerpts for the chosen words that you can scan and take action on.

### EXCEL TEXT/SPEECH FUNCTION
This allows Excel to speak through a list of numbers. This lets you check them off on the source document without having to look back to the monitor. Pretty slick.

### READ THE "TECH Q&A" COLUMN IN THE JOURNAL OF ACCOUNTANCY
This gives you extremely practical Word, Excel, and Outlook tips. It's short, to the point, and hey, many of you are already getting the magazine.

### CLEAR THE DECKS
It's hard to focus your concentration when there are several other things on your desk distracting you from what needs to get done now.

### CLOSE OUTLOOK
Wean yourself off of constantly checking email! You're in the middle of a report, email comes in, and you get sidetracked by a joke, a conference announcement, or a client request that you think will only take a few minutes to respond to. By the time you're ready to get back to the task, you forgot where you left off. The lost time adds up. Set appointed times during the day to check your inbox. I started by only checking hourly. Generally, I am now down to first thing in the morning, 11:30 am, and 4:30 pm.

### USE A RSS NEWS AGGREGATOR
This will gather the information from the blogs and news sources you read anyway. This saves you time by not having to check individual web sites (even if you've stored them in Favorites) or reading individual emails as the news posts come in. I use Google Reader, which I view first thing in the morning or at the end of the day. I quickly scan all of the stories and decide which ones to read. And I can "star" the important ones to easily find them at a later date.

### MASTER WORD® AND EXCEL®
This will enable you to take advantage of the features and shortcuts that will allow you to function more efficiently. I am amazed by the number of people who don't bother to learn much beyond the basics of the tools we use the most to prepare our work product.

### LEARN NEW SOFTWARE, CHEAP
Go to www.lynda.com. For as little as $25 per month, you get unlimited, any time access to on-line tutorials. Choose by Subject (e.g., podcasting), Product (e.g., Excel) Vendor (e.g., Corel) or Author (whoever). Sorry, no CPE credits.

So there you go. I now say unto you, be fruitful and multiply … your productivity. And special thanks to those people who took the time to respond to my request for input for this article. ∞

# Guideline Company Transaction Method: When Comparables Sold Before the Financial Markets' Meltdown

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There has been much discussion and debate in the valuation community about how business valuators should adjust for the global economic meltdown that has occurred over the last two years. I recently had a marital dissolution case where this issue became even more critical.

## BACKGROUND

In this case, let's assume that I was representing the husband. The wife owned a software development company that we were valuing. As one of my valuation methods, I applied the guideline company transaction method. We found extensive transactions in the private transaction databases (Pratt's Stats, Bizcomps, DoneDeals, Mergerstat Review, and IBA).

We narrowed our field to five transactions that we considered to be the most comparable. However, the sales dates were as early as 2004 and as late as the first half of 2007. Thus, all of these transactions were prior to the current economic meltdown.

The wife's expert argued that my transactions could not be relied upon. He said the current economic slowdown is the worst recession since the Great Depression. (As a side note, I agreed with him on this point.) He argued that my transactions were not indicative of current prices being paid for similar businesses because these transactions all occurred before the current economic slowdown. At our valuation date, the S&P 500 Index had dropped by over 40% from its October, 2007 high.

On the face of it, the wife's expert seemed to have a good argument. However, this is an excellent example of how important it is to look below the surface in our valuation work. I had recognized this potential issue as we developed our valuation. I clearly recognized that the economic slowdown could not be ignored, whether I was engaged by the husband or by the wife. I also felt strongly that our guideline transaction companies were very comparable based upon their similarities with the subject company. ***However, how was I to address the dramatic drop in public markets' pricing multiples since our guideline transactions' sales dates?***

## ALTERNATIVES CONSIDERED

Of course, well before wife's expert raised this issue, we were clearly aware that we must consider the public financial markets' decline. As we evaluated the appropriate approach to use in adjusting for this decline, we looked at a number of alternatives, as follow:

1. Make no adjustment to the guideline transactions' sales prices.
2. Adjust the guideline transactions' sales prices in proportion to the price declines in public markets (for example, the S&P 500 Index) from sales date to valuation date. For example, assume that a guideline transaction sales date was December, 2006. Also assume that the S&P 500 declined by 30 percent from December, 2006 to the valuation date. Under this alternative, the guideline transaction sales price would be reduced by 30 percent.
3. To each guideline transaction's sales price, apply the decline in prices of publicly traded shares in the same industry from each transaction date until the valuation date. Thus, for example again assume that a guideline transaction sales date was December, 2006. Also assume that the stock price of public company A (a software development company) declined by 25 percent from December, 2006 to the valuation date. Under this alternative, the guideline transaction sales price would be reduced by 25 percent.

As we evaluated each of these alternatives, we found theoretical problems with them as follows:

1. No Adjustment: Making no adjustment for the worst recession since the Great Depression could greatly hurt my credibility.
2. Use the decline in public markets: How could we establish that the decline in a public market index was indicative of the decline in prices that a comparatively small software development company would sell for?
3. Use the decline in public companies in the same industry: Of these three alternatives, we found this one to be the most appropriate. However, in the valuation process we had concluded that there were no sufficiently comparable guideline public companies as compared to the subject company. If that was the case, how could we use those same public companies to adjust for the drop in the market?

***If none of these alternatives were appropriate, how were we to adjust for the recession?***

The opposing expert took the position that none of these guideline transactions could be considered because of the horrific meltdown in the economy and the dramatic reduction in risk tolerance that investors are willing to accept. Before we completed our valuation, we had anticipated this argument. We were left with the

*Continued on next page*

dilemma of how to bridge the gap between pre-meltdown transactions and December, 2008 valuation date.

### MERGERS AND ACQUISITIONS EXPERT

As we evaluated this issue of "bridging the gap" we determined that it was appropriate to bring in an expert in the sales of software development companies. Of course, locating such a person can be easier said than done. We were very fortunate to locate Jeff Sussman, who specializes in the purchase and sales of software development companies throughout the United States. We were also fortunate that Jeff had headquarters in Denver, Colorado where we practice.

As we discussed this project with Jeff, it became clear that it would be beneficial to have a separate report prepared by him. While I could rely on my discussions with him, I really wanted to have the power of his report and his testimony to back up my report and testimony.

Jeff's opinion, as stated in his report was that the economic meltdown had had an impact on the sale of software development companies; however, that impact did not result in a drop in the price for which these companies were sold. Rather, the impact of the financial meltdown has caused software development companies to be on the market for a longer period of time.

Did that affect our value? Certainly, in that it had an impact on a marketability discount. However, it allowed us to rely on the database transactions prior to October, 2007 and adjust appropriately in the marketability discount.

### OUTCOME OF THE CASE

This case was submitted to non-binding mediation prior to the court date. The mediator first heard the opposing expert's argument that my transactions could not be comparable because they did not consider the financial meltdown. When the mediator met with us, I explained that we had adjusted for that based on the report prepared by Mr. Sussman. She seemed quite surprised at that and appeared to discount the opposing expert's valuation opinion and theory thereafter.

The case was ultimately settled with substantial weight given to our value derived from the guideline company transaction method. Had we not had Mr. Sussman's input, expertise, and report, I doubt that the settlement would have been as favorable to our client.

If anyone needs assistance with valuing, buying or selling software development companies, Jeff Sussman can be contacted at: (303) 521-7877 and jeff.sussman@gmail.com.

# A Look at Reasonable Compensation

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Reasonable compensation has been in the headlines quite a bit lately as the U.S. government has been cracking down on excessive compensation paid by public companies, particularly those receiving bailout money. Accountants have been dealing with this topic for decades in the business valuation, litigation support, and tax arenas.

The concept of reasonable compensation is derived from §162(a) of the Internal Revenue Code. According to this section, a business may deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including - a reasonable allowance for salaries or other compensation for personal services actually rendered."[1]

The recent Appellate Court decision in *Menard, Inc. and John R. Menard, Jr., v. Commissioner of Internal Revenue,* 560 F. 3d 620 (7th Cir. 2009) reflects a common sense approach to the analysis of reasonable compensation.

The *Menard* case involves the 1998 compensation of John R. Menard Jr.,[2] Chief Executive Officer of Menard, Inc. At the time, the Company was the third largest retail home improvement store in the country with 138 stores.[3] Mr. Menard formed the Company in 1962 and has served as the Company's CEO since. During the time period analyzed, he worked twelve to sixteen hour days, six or seven days a week, and took one week of vacation per year.[4] By all accounts, Mr. Menard was involved in every aspect of the Company's operations.

In 1998, Mr. Menard received the following compensation:

| | |
|---|---|
| Base salary | $ 157,500 |
| Profit sharing bonus | 3,017,100 |
| Additional bonus | 17,467,800 |
| | **$20,642,400** |

This additional bonus represented 5 percent of the Company's pre-tax income, in accordance with a bonus program adopted in 1973. The Company's revenue in 1998 was $3.4B, its pre-tax income was $315M, and its return on equity was 18.8 percent.

In 2004, the U.S. Tax Court allowed approximately $7.1M of Mr. Menard's $20M compensation based on the following:

1. Home Depot's return on investment (16.1%) times the compensation of Home Depot's CEO ($2,841,307) equals $534,166.
2. $534,166 divided by Menards' return on investment (18.8%) equals $3,317,799.
3. $3,317,799 times the compensation of Lowe's' CEO to that of Home Depot's CEO (2.13) equals $7,066,912.
4. $7,066,912 was the compensation allowed by the IRS.

Under appeal, the Seventh Circuit reversed the Tax Court's decision finding the following:

- Tax Court failed to consider the full compensation packages of the other executives.
  - o The CEO of Home Depot was paid $2.8M that year. Home Depot had a return on equity of 16.1 percent (compared to Menard's 18.8 percent).[5]
  - o The CEO of Lowe's was paid $6.1M that year.[6]
  - o Robert Nardelli became the CEO of Home Depot two years later. Over his reign from 2001 to 2007, he was paid $124M in salary (excluding stock options). His severance package was valued at $210M (including stock options).
- Tax Court did not consider the differences in responsibilities and performance.
  - o Tax Court ignored that Mr. Menard performed work that was delegated to staff in the other companies.
  - o Tax Court ignored the hours worked of the individuals.
- Tax Court did not look at the challenges faced by the other executives and the level of risk in receiving the level of compensation.
  - o If the company's earnings were lower, Mr. Menard's compensation would have been lower (potentially as low as $157,500).
  - o The Tax Court ignored past compensation levels.
  - o The riskier the compensation structure, the greater one's salary would need to be to compensate for bearing the additional risk.
- A shareholder-employee should be treated like any other

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employee. If an incentive bonus plan is appropriate for non-shareholder employees, it should be appropriate for shareholder employees.
- Tax Court's formula was "arbitrary" and "dizzying."

**2008 STATISTICS FROM www.CompanyPay.com**

| Company | CEO Total Compensation | Revenue | Profit/(Loss) |
|---|---|---|---|
| General Motors | $14.4M | $182.3B | ($38.7B) |
| Ford | 21.7M | 172.4B | ( 2.7B) |
| Walmart | 31.6M | 378.8B | 12.7B |
| Exxon Mobil | 16.7M | 372.8B | 40.6B |
| Chevron | 31.5M | 210.8B | 18.7B |
| Home Depot | 8.3M | 84.7B | 4.4B |
| Lowe's | 6.2M | 48.3B | 2.8B |
| CVS | 26.1M | 76.3B | 2.6B |

As addressed by the Appellate Court in the *Menard* case, for income tax reporting purposes (as well as business valuation and litigation support purposes), one needs to consider the entire compensation package of an individual, which many include any/all of the following:
- dividends
- insurance benefits
- non-cash benefits
- paid time off
- payment for actual services rendered
- perks or business expenses being deducted by the business[7]
- retirement plans
- severance packages
- stock options or other deferred compensation

Reasonable compensation may be established by looking at what would be paid in an arms' length transaction for the performance of the same duties. The company does not have to replace the salary of an owner with that of another owner. Often times, an owner could be replaced with an employee.

Court decisions regarding reasonable compensation tend to address two separate tests – the Multi Factor Test and the Independent Investor Test. The Multi Factor Test looks at the specific factors that need to be considered in the determination of reasonable compensation. The Independent Investor Test presumes the owner/employee's compensation is reasonable as long as business owners are receiving their expected rates of return. The Independent Investor Test is often used in conjunction with the Multi Factor Test.

Both of these tests are often used in the analysis of reasonable compensation for business valuation and litigation support purposes. For example, when a valuator is determining an individual's compensation, all of the duties he/she performs must be determined and analyzed separately (Multi Factor Test). Compensation often needs to be determined for each duty performed.

The following list includes factors to consider, in the Multi Factor Test, to assess reasonable compensation. Not all factors are applicable in every case and each case is facts and circumstances specific.
- Company factors
  - o Earnings history and (in)stability
  - o Nature of the business or professional practice
    - Peculiar characteristics of the company
    - Size and complexities of the company
  - o Net earnings of the company
  - o Salary policy
  - o Unique traits of the company
- Comparisons
  - o Comparable positions in comparable companies (especially when they are arms' length transactions)
  - o To company's gross and net income
  - o To other employees of the company (again, especially when they are arms' length transactions)
  - o To prior years for the same individual
- Employee factors
  - o Contributions to the company's success
  - o Duties and responsibilities
    - Multiple roles
    - When an individual wears many hats, it may be appropriate to allocate that person's time and duties or responsibilities to each position to arrive at total compensation for that person.
  - o Education
  - o Experience
  - o Guarantee of debt
  - o Hours worked
  - o Other benefits offered to employee
  - o Performance
  - o Qualifications and skill set
  - o Role in the company
  - o Salary history
  - o Scarcity of qualified replacement employees
  - o Type and extent of services provided
- Outside factors
  - o Demographics of area serviced
  - o Economic conditions
  - o Geographic area

The Independent Investor Test presumes the owner/employee's compensation is reasonable as long as business owners are receiving their expected rates of return.
*Continued on next page*

The concept here is that if an independent investor in the company is considered to be receiving a satisfactory arms length return on his or her investment, then the amounts being paid to the owner-employee(s) must be reasonable in relation to the remaining returns available at the investor level.

The following court cases are often referred to in discussions regarding reasonable compensation:

1. *Ackerman v Ackerman,* In re Marriage of, Cal. App, 4th, Dec 27, 2006
2. *Beiner, Inc. v. Commissioner*, T.C. Memo 2004-219
3. *Brewer Quality Homes, Inc. v. Commissioner,* T.C. Memo 2003-200
4. *Eberl's Claim Service, Inc. v. Commissioner* [2001-1 USTC ¶50,396], 249 F.3d 994, 999 (10th Cir. 2001)
5. *Elliots, Inc. v. Commissioner* [83-2 USTC ¶9610], 716 F.2d 1241 (9th Cir. 1983)
6. *Exacto Spring Corp. v. Commissioner* [99-2 USTC ¶50,964], 196 F.3d 833 (7th Cir. 1999)
7. *Haffner's Service Stations, Inc. v. Commissioner* [2003-1 USTC ¶50,333], 326 F.3d 1, 3-4 (1st Cir. 2003)
8. *JD & Associates, Ltd. v. United States of America*, North Dakota District Court, Case No. 3:04-CV-59
9. *LabelGraphics, Inc. v. Commissioner* [2000-2 USTC ¶50,648], 221 F.3d 1091, 1095 (9th Cir. 2000)
10. *Mad Auto Wrecking, Inc. v. Commissioner,* T.C. Memo 1995-153, 69 TCM 2330
11. *Miller & Sons Drywall v. Commissioner,* T.C. Memo 2005-114
12. *Pediatric Surgical Associates, PC v. Commissioner,* T.C. Memo 2001-81
13. *Pulsar Components, Inc. v. Commissioner,* T.C. Memo 1996-129
14. *Rapco, Inc. v. Commissioner* [96-1 USTC ¶50,297] 50,297], 85 F.3d 950, 954-55 (2d Cir. 1996)
15. *Rutter v. Commissioner* [88-2 USTC ¶9500], 853 F.2d 1267, 1271 (5th Cir. 1988)
16. *Patricia A. Schade v. Jack B. Gethmann,* No. 5-744 (Iowa App. November 23, 2005)
17. *Pediatric Surgical Associates,* T.C. Memo 2001-81
18. *Trucks, Inc. v. U.S.*, 588 F. Supp. 638 (D.C.Neb.1984)
19. *Universal Marketing, Inc. v. Commissioner,* T.C. Memo 207-305
20. *Wechsler & Co. v. Commissioner of Internal Revenue,* T.C. Memo 2006-173

Once the valuator has determined the duties of the individual, the amount of compensation to be paid must be determined. Some sources for this data include:

1. Classified ads
   - Place an ad in the local newspaper. What is the salary range of qualified respondents?
2. Company management
   - One of the most important steps in the valuation process is interviewing company personnel. In addition to discussing duties, it is usually helpful to ask what they would pay someone else to perform the duties at hand… and why.
3. Compensation/vocational expert
4. Personal and professional contacts
   - As an accountant, you may have clients with infor mation that may be useful during your analysis. Of course, you may not disclose any particulars about the case you are working on, but you still may be able to obtain useful data from your contacts.
5. Published data sources (to be discussed in detail later in this article)
6. Recruiters
7. Trade associations
   - Trade associations may have surveys or published articles available.
   - Additionally, you may be able to call the associa tion to obtain information

When comparing compensation of one individual to another, it is imperative to know what is included in the data. Compensation may include any or all of the following:

1. Salary
2. Bonus
3. Benefits
4. Make up of compensation
5. Profit sharing component
6. Stock options or other deferred compensation

The valuator must be sure that market compensation utilized represents compensation for the duties performed rather than ownership status (or return on investment). In order to defend your computations, you need to know:[8]

1. Is the data collected on a national or regional basis?
2. Does the data include owner/employees where the amount of compensation reported may also include business profits as compensation (i.e., partners in professions and businesses)?
3. Concerning data from business and professional associations, what are the sampling sizes that relate to the subject valuation?
4. When using SIC codes in identifying comparables, how do the particular characteristics of the subject company compare with the broader range of companies covered by the SIC code?
5. How does the data use/define the job titles, and are the actual duties comparable to the duties/hours of the subject owner/employee?
6. How does the data survey reflect averages? Medians? Quartiles?
7. Does the survey fairly reflect compensation for people

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with particular niches and sub-specialties: i.e., matrimonial attorneys, forensic accountants, lobbyists, etc.?

8. Does the valuator need to include multiple job titles from the survey data to cover the owner/employee's duties?
9. What is the reliability of the statistics and sources that the survey uses?
10. Where applicable, are stock options, restricted stock, shadow stock compensation, as well as other perks reflected in the data survey, and comparable to owner/employee in question?
11. Were all companies in the database consistent in having/not having retirement plans separate from salary?
12. Is the owner a "key person" in the business or a top performer/sales generator?

**The following section contains a comprehensive listing of data sources to be utilized in determining reasonable compensation.**

1. Abbott-Langer
   a. www.abbott-langer.com
   b. Prices start at $245
   c. Specializes in nonprofits
   d. Conducts surveys for associations for and on behalf of their members
   e. Reports of actual data points collected and calculations of simple averages, percentiles, counts and rates of error by industry
   f. Snapshot as of March 31 each year
   g. Partner with ERI (see below)
2. BLR
   a. www.compensation.blr.com
   b. Basic single user subscription price is $895 Other options are available
   c. Data based on surveys conducted by BLR
3. CCH's Almanac of Business and Industrial Financial Ratios
   a.http://onlinestore.cch.com/ productdetail.asp? productid=5265
   b. Printed material and CD
   c. Single copy price is $201
   d. Annual updates
4. Career One Stop
   a. www.careeronestop.com
   b Free
   c. Wage and salary data by occupation and location
   d. Data from the Occupational Employment Statistics (OES) surveys conducted by the Bureau of Labor Statistics (BLS) at the U.S. Department of Labor
   e. Annual updates
5. Compdata Surveys by Dolan Technologies Corp.
   a. www.compdatasurveys.com
   b. Prices start at $40 for individual job reports
   c. Executive compensation book and/or CD pricing starts at $499
   d. Compensation data results book and/or online pricing starts at $838
   e. Compensation data includes benefits, pay practices and 600 job titles with local, statewide and regional breakouts
   f. Executive Compensation surveys provide national and regional data for more than 40 executive positions
   g. Results include base pay, total compensation, incentives, and perquisites
6. Economic Research Institute (ERI)[9]
   a. www.erieri.com
   b. $2,389/annual subscription
   c. ERI's Assessor Series values are derived 100% from employer-provided input, including digitization of records, leased datasets, and ERI's proprietary salary surveys, all targeted to specific jobs
   d. Cross-verified and statistically tested numbers
   e. ERI holds the U.S. patent on internet pay and cost of living surveys
   f. Professional Edition is for wage and salary planning
   g. Consultant Edition is for in-depth research for consulting, compliance, or litigation support or for salary planning in which executive and director level positions are included
   h. Numerous versions available
      i. Salary Survey Assessor
      ii. Geographic Pay Assessor
      iii. Relocation Survey Assessor
      iv. Executive Compensation Assessor
      v. Nonprofit Comparables Assessor
      vi. Occupational Assessor (eDOT)
   i. Quarterly updates
   j. Comparable to Watson Wyatt Data Services, Mercer, and Radford
7. Equilar
   a. www.equilar.com
   b. Call 877- 441-6090 for pricing
   c. Executive compensation and board compensation
   d. Data for publicly held companies
8. The Management Association of Illinois
   a. http://www.hrsource.org
   b. Print and PDFs available with prices ranging from $200 to $825
   c. Updated annually
   d. Versions available:
      i. Executive Compensation Survey
      ii. Wage Survey
      iii. Salary Survey

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iv. Nonprofit Survey
v. National Wage & Salary Survey
vi. National IT & Engineering Compensa tion Survey
vii. National Sales Compensation & Practices Survey

9. Mercer Compensation Surveys
   a. www.mercer.com
   b. More appropriate for public company and industry use
10. Microbilt's (formerly Integra Information) Officer Compensation Reports
   a. http://microbilt.com
   b. contact: Jan Tilley
      i. email Jan_Tilley@microbilt.com
      ii. 800-443-4397 x 4523
   c. monthly minimum/service fee applies
   d. 33 different data sources
11. PAQ Global Salary Calculator
      i. http://www.globalsalarycalculator.com/
      ii. Downloadable salary calculator
      iii. Data are derived from job family norms
      iv. Affiliate of ERI
      v. Comparable to U.S. Occupational Employment Statistics, Salary.com, Payscale.com
12. Payscale
   a. www.payscale.com
   b. Free
   c. Employee and employer data included in surveys
   d. Data is filtered before included in database.
13. Radford
   a. www.radford.com
   b. More appropriate for public company and industry use
14. Risk Management Association's Annual Statement Studies and eStatementStudies
   a. www.RMAhq.com
   b. Nonmember pricing begins at $220.
   c. Based on information reported by credit grantors
   d. Includes officers, owners, and directors' compensation as a single group
   e. Not broken down geographically
   f. Number of officers unknown
   g. Number of officers that are owners is not known
15. Salaries Review
   a. www.salariesreview.com
   b. $19 per report
   c. Average, low, and high wages and salary data for any one of 4,000 positions and any of 6,000 cities worldwide
   d. Effectively ERI's total data warehouse
   e. On-line, real-time databases
   f. Data gathered from compensation and benefits professionals, one-time Human Resource and Internet inquirers, and non-copyrighted sources.
   g. Nonverified and anonymous data
   h. Snapshop at March 31 each year
16. Salary.com:
   a. www.salary.com
   b. Prices vary
   c. Employer reported data
   d. Does not include data from individual site users, placement agencies, or job postings
   e. Based on compensation survey reports from compensation consulting firms
   f. Monthly updates
17. Salary Expert[10]
   a. www.salaryexpert.com
   b. An affiliate of ERI
   c. SalaryExpert's estimates are derived from these generalized job family data collections:
      1) input via www.globalsalarycalculator.com using ERI's C3 Job Family Matrix
      2) data leased from countries' national statistics offices (BLS OES in the U.S.), and 3) employee-provided data
   d. Derived from a distributed ranking of competencies within job families
   e. Unadjusted for size or industry and heavily influenced by employee inputs
   f. Typically 89% of ERI's Assessor Series employer provided values
18. Salary Wizard
   a. www.salarywizard.com
   b. Free
   c. Source of data is www.salary.com
   d. Data is intended to provide a reasonable range for typical cash compensation earned by the typical person working in that job.
   e. Based on the pay practices of companies of all industries, sizes, and all over the U.S.
   f. Data represents national average practices
   g. Metro or zip code level data is based on a geographic salary equivalent factor (similar to a cost-of-living adjustment factor).
19. Governmental Sources
   a. Bureau of Labor Statistics
      i. Data available by geographic area, occu pation, and industry
      ii. Wages by area and occupation http://www.bls.gov/bls/blswage.htm
      iii. Earnings based on demographics, education, and industry http://www.bls.gov/cps/earnings.htm #demographics
      iv. Quarterly Census of Employment and Wages
         1. http://www.bls.gov/cew/

*Continued on next page*

2. Quarterly count of employment and wage data reported by employers covering 98 percent of U.S. jobs, available at the county, MSA, state and national levels by industry

v. National Compensation Survey
1. http://www.bls.gov/ncs/home.htm
2. Comprehensive measures of occu pational wages, employment cost trends, and benefit incidence and detailed plan provisions.
3. Occupational earnings are available for metropolitan/non-metropolitan areas, broad geographicregions, and on a national basis.
4. Average hourly employer cost for employee compensation

vi. Occupational Employment Statistics
1. http://www.bls.gov/oes/
2. Employment and wage estimates for over 800 occupations
3. Estimates of the number of people employed in certain occupations, and of the wages paid to them
4. Self-employed persons are not included in the estimates.
5. Available for the nation as a whole, for individual states, and for metro politan areas
6. National occupational estimates for specific industries are also available.

The next page presents various sources for compensation data specific to the accounting, legal, and medical industries.

When using any of this data, you have to remember to compare apples to apples. Be sure you read the information about the surveys to know you are comparing the same components.

The determination of reasonable compensation is paramount in the business valuation and litigation support arena because it is often a significant adjustment having considerable impact on the overall value of the entity. After you have completed your analysis, it is often helpful to ask the question "Would the level of compensation be acceptable to all parties if the transaction were in an arms' length relationship?" If your answer is yes, you likely have arrived at a fair conclusion.

## COMPENSATION DATA SOURCES FOR THE ACCOUNTING, LEGAL, AND MEDICAL INDUSTRIES

### ACCOUNTING

1. Institute of Management Administration's CPA Firm Statistical Analysis Reference Handbook
   a. http://www.ioma.com/issues/SPCRPT/1619047-1.html
   b. Price - $449
   c. Numerous statistics presented, not only compensation
2. Robert Half International
   a. http://www.rhi.com/SalaryGuides
   b. Also provides compensation data for the administrative and information technology fields/starting salaries in legal profession
3. Rosenberg Associates MAP Survey
   a. http://www.rosenbergassoc.com/html/mapsurvey.html
   b. Price - $450
   c. Numerous statistics presented, not only compensation

### LEGAL

1. Incisive Legal Intelligence Surveys (formal Altman Weil)
   a. http://www.incisivesurveys.com/r5/cob_page.asp?category_id=56850
   b. Survey of Law Firm Economics available as PDF download for $925
   c. Small Law Firm Economic Survey (20 or fewer attorneys) available as PDF download for $495
   d. Data Collected
      i. Income
      ii. Expenses
      iii. Unbilled time
      iv. Receivables
      v. Realization
      vi. Hourly rates
      vii. Billable hours
      viii. Partner compensation
      ix. Associate compensation
      x. Administrative staff compensation
      xi. Personnel ratios
   e. Positions analyzed:
      i. equity partner/shareholder
      ii. non-equity partner/shareholder
      iii. associate lawyer
      iv. staff lawyer
      v. of counsel
   f. Data analyzed by:
      i. national
      ii. regional
      iii. state
      iv. population size
      v. practice area
      vi. year admitted to the bar
      viii. years of experience
      viii. individual lawyer specialties (litigation and non-litigation)
2. Robert Half International
   a. http://www.rhi.com/SalaryGuides
   b. Starting salaries in the legal profession

### MEDICAL

1. American Medical Group Association
   a.https://commerce.amga.org/store/category.cfm?category_id=2
   b. Medical Group Compensation & Financial Survey
   c. Print/online versions available starting at $550 for non-members
2. Medical Group Management Association
   a. www.mgma.org
   b. Pricing varies. Lower prices available for MGMA members.
   c. Books and CD versions available
   d. Primarily based on surveys completed by members
   e. Annual updates
   f. Versions available:
      i. Academic Practice Compensation and Production
      ii. Physician Starting Salary
      iii. Management Compensation
      iv. Physician Compensation and Production
3. Merritt Hawkins and Associates
   a. www.merritthawkins.com
   b. Staffing company
   c. Free
   d. 2008 surveys:
      i. Final year residents
      ii. Primary care physicians
   e. 2007 surveys:
      i. Physicians age 50-65 years old
      ii. Primary care physicians
      iii. Recruiting incentives
4. Sullivan Cotter and Associates, Inc.
   a. www.sullivancotter.com
   b. Physician compensation and production surveys
   c. Similar to MGMA
   d. More specialties
   e. Total cash compensation

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[1] Internal Revenue Code Section 162(a)(1).
[2] Mr. Menard owned 100% of the Company's voting stock and 56% of the non-voting stock.
[3] Behind Home Depot and Lowes. In 2009, the Company has plans to open its 250th store. It is still the third largest home improvement chain based on retail sales dollars.
[4] In 2003, a few Home Depot Vice Presidents received four and five weeks' vacation as part of their employment contracts (Sources: http://www.secinfo.com/d11MXs.36nw.d.htm and http://www.secinfo.com/d11MXs.36nw.c.htm). Corporate employees at Lowe's generally receive two weeks of vacation immediately (Source: http://en.wikipedia.org/wiki/Lowes). Author was not able to locate more detailed information.
[5] See sidebar for 2008 information on the CEO of Home Depot and Lowe's as well as a few other large public companies.
[6] Lowe's return on equity was lower than Home Depot's and Lowe's is smaller than Home Depot, yet Lowe's CEO earned more than double the CEO of Home Depot.
[7] The IRS is more concerned when expenses are being deducted by the company but not reported as income by the individual.
[8] Schiller, Donald C. 2006 AAML/AICPA National Conference on Divorce.
[9] A special thank you to E. James Brennan, Senior Associate of ERI Economic Research Institute, for providing information on ERI and its affiliated products. ERI is also the data source for www.CareerBuilder.com.
[10] http://www.salaryexpert.com/index.cfm?fuseaction=Main.JobFamilyMeth.

# Discovery of Draft Reports: How Do You Spell Relief?

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The scene is a conference room of a law firm and you are being deposed relative to your expert opinions in a litigation matter. You answer the preliminary questions related to your background, who it was that retained you, the purpose and scope of your work in the matter, and a summary of the opinions you intend to render at trial. Your report is marked as Exhibit 2, and you are asked something similar to the following, "Mr. Boyle, is Exhibit 2 the only draft of your report or is it one of several that existed as your opinion evolved?" You respond that your report is the final iteration of an ongoing process of developing your final work product, which of course opposing counsel has in his/her hands.

Next question, "Were any of these iterations as you call them, I'll just call them drafts, shared with your client or client's counsel?"

You answer "Yes, some were shared with client's counsel."

"Mr. Boyle, may I see those draft reports?"

"Objection!" barks counsel for your client, who suddenly comes alive at this request and then continues. "Discovery is precluded under the attorney work-product protections of the Federal Rules of Civil Procedure (FRCP) 26(b) (3) and (4) and the U.S. Supreme Court decisions of *Hickman v. Taylor,* 329 U.S. 495 (1947) and *Upjohn Co. v United States,* 449 U.S. 383 (1981), which protects an attorney's core work product ( the lawyer's mental impressions, opinions, legal theories), and trial preparation materials."

And they're off— before you know it, a trial within a trial has begun to force production of your draft reports— to hell with the merits of your final opinion, which has now become a side issue. The conflict is ultimately resolved by the judge who, in line with the majority of court decisions on this topic since 1993, orders you to produce the draft reports. However, you did not understand the document retention requirements of the FRCP and consequently, you did not retain the drafts. Regretfully, like other experts who did not fully understand the Rules, you have exposed yourself and your firm to a potential spoliation claim.

## BACKGROUND

How did we get to this point and what can be or is being done about it? By way of background, prior to 1993, (FRCP) 26(a)(2)(B) required that the report of an expert witness contain data or other information *relied upon* by the witness in forming the opinions expressed in the report. In the 1993 amendments to the FRCP, the wording of this provision was changed to require the expert report to disclose the data or other information *considered by* the expert witness in forming his/her opinions, a much broader disclosure requirement. The 1993 Committee Notes accompanying the amendment underscored the significance of the change: "The report is to disclose the data and other information considered by the expert and any exhibits or charts that summarize or support the expert's opinions. Given this obligation of disclosure, litigants should no longer be able to argue that materials furnished to their experts to be used in forming their opinions— whether or not ultimately relied upon by the expert— are privileged or otherwise protected from disclosure when such persons are testifying or being deposed."

Since 1993, this revised language, "data or other information considered by the witness……whether or not ultimately relied upon by the expert" has gradually been defined by courts to include not only facts or data provided to the expert, but also all draft expert reports and all attorney communications with the expert. As a result, post-1993 discovery began to focus on the expert's draft reports and the associated discussions with legal counsel as a way to gain deeper insight into the opposing litigators' mental impressions, conclusions, and/or legal theories, all of which are protected from discovery by FRCP 26(b)(3). Hence the expert witness, who needs to interact with counsel to gain insight that is critical to his/her opinions, often finds himself/herself in a tug of war between expert full disclosure and attorney work product protection. In recent years, more and more time (and expense) has been spent by experts explaining and defending draft reports that may not be relevant to the final opinions expressed in the case.

*Continued on next page*

*expert* **TIP**

**Hopefully, long overdue relief with respect to the production of draft reports is on the way. As expert witnesses, we believe proposed amendments will avoid expensive discovery disputes and focus the attention of both parties on the merits of the expert's opinions and conclusions offered at trial.**

### DISCOVERABILITY OF DRAFT REPORTS

Prior to being addressed by the courts, litigators were divided as to whether or not an expert's draft report was "data or other information considered by the witness." Additionally, considerable disagreement existed over the question of what constituted a draft. Is a draft created only when a version of the report is transmitted (electronically or in hard copy) between an expert and an attorney? Alternatively, is a draft created every time the expert revises the report, even if certain revisions are never transmitted and are deleted before the report is finalized? As to the latter question, many experts believe that their electronic work product is a work-in-progress and if not shared with anyone outside the firm, is not subject to discovery and hence does not need to be retained.

The issue of discoverability and retention was addressed in *Trigon Insurance Company vs. United States* (277 F.R.D. at 240, E.D. VA 2001), where the Court found that draft reports are discoverable once they are shared with legal counsel or others outside the expert's firm. Since the testifying expert did not retain draft reports shared with legal counsel, the Court found the expert liable for spoliation of evidence and gave an adverse inference instruction. As a result, it is now generally understood that where there is an obligation of production, there is a corresponding obligation of preservation.

### IS RELIEF ON THE HORIZON?

The Committee on Rules of Practice of the Judicial Conference of the United States (Committee) recently proposed amendments to the Federal Rules of Civil Procedure. Among other proposed amendments, the Committee recommended amending Rules 26(b)(4)(B) and 26(b)(4)(C) to extend the work product protections of Rule 26(b)(3) to shield from discovery the drafts of expert reports, and with three exceptions, to communications between the expert witnesses and the counsel who retained them, regardless of whether those communications are oral, written, electronic, or by any other means.

The three exceptions that would not be protected from discovery are:

1. Attorney-expert communications directed to the expert's compensation
2. Identifying facts or data the attorney provided to the expert that the expert considered in forming the opinions expressed in the final expert report, and
3. Identifying assumptions the attorney provided to the expert that the expert relied upon in forming the opinions expressed in the final expert report.

The Committee invited public comment as to whether eliminating the discovery of draft expert reports and certain communications between the expert and the attorney would affect either party from adequately testing the expert's opinions expressed in the final expert report. The deadline for submission of comments was February 17, 2009.

### AICPA SUBMITS COMMENT LETTER

In response to the Committee's invitation for public comment, the AICPA Forensic & Valuation Services Executive Committee, in concert with the Forensic & Litigation Services Committee, submitted a comment letter to the Committee. In its comments, AICPA supported the proposed revisions to Rule 26(b)(4)(B) and (C), as current discovery requirements often favored companies with the financial resources to retain both a consulting and testifying expert. Such retention, while more expensive, allows the attorney to properly vet theories with the consulting expert that are not as easily discoverable as that person is not preparing a report or providing an opinion in the matter. Secondly, the AICPA pointed out the fact that parties often engage in expensive discovery

disputes that divert the attention away from the merits of the expert's opinions to be rendered at trial and such a change would eliminate unnecessary time and expense in assembling and producing information that is rarely used at trial. In the absence of a change in Rule 26(b)(4)(B) and (C), the AICPA suggested revising Rule 26(a)(2)(B) to once again require the expert report to contain the facts or data relied upon rather than considered by the expert witness.

### WHAT HAPPENS FROM HERE?

The Advisory Committee will submit the proposed rule amendments to the Standing Committee on Rules and Practice and Procedure, which will decide whether to approve the proposed amendments for consideration by the full Judicial Conference of the United States at its annual meeting in September, 2009. Should that occur, the amendments will then be transmitted to the U.S Supreme Court, which will prescribe the amendments to Congress before May 1, 2010. Absent congressional action, the proposed amendments to Rule 26 would become effective December 1, 2010.

Hopefully, long overdue relief with respect to the production of draft reports is on the way. As expert witnesses, we believe proposed amendments will avoid expensive discovery disputes and focus the attention of both parties on the merits of the expert's opinions and conclusions offered at trial. ♋

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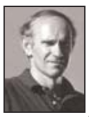

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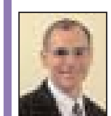

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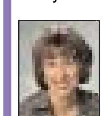

**STACEY D. UDELL, CPA/ABV/CFF, ASA, CVA** is a partner in the Moorestown, NJ office of Gold Gocial Gerstein LLC. She serves on the NACVA Litigation Forensics Board, the NJ State NACVA Chapter Executive Board, and has been on planning committees for these groups' conferences. In 2008, Ms. Udell was a contributing author to the *Business Valuation Resources Healthcare Industry Valuation Guide.*

## PANEL OF EXPERTS, cont.

**DANIEL R. VAN VLEET, ASA, CBA** is a managing director at Stout Risus Ross, Chicago. He serves on the BV Committee and Board of Governors of the ASA. He has taught graduate BV courses at DePaul and Northwestern universities and is a frequent lecturer and author. His practice includes BV, financial advisory services and economic analysis for litigation, taxation and transaction matters.

**RICHARD M. WISE, FASA, MCBA, FCA, FCBV, CA/IFA, CFE** is founder of Wise Blackman. Past president of the Canadian Institute of Chartered Business Valuators and former governor of the ASA, he is a Fellow of the Ontario Institute of Chartered Accountants, author of *Financial Litigation - Quantifying Business Damages and Values*, co-author of *Investigative and Forensic Accounting Practice Issues* (CICA), and a member of the ASA BV Committee and Standards Subcommittee.

**DONALD P. WISEHART, ASA, CPA/ABV, CVA, MST** is owner of Wisehart, Inc., a Rhode Island CPA and consulting firm and member of The Financial Consulting Group. With 30 years of professional experience, he has given numerous BV presentations and has developed several courses for NACVA, where he chaired the Education Board. Don was also founding president of the Rhode Island Business Appraisal Group.

**KEVIN R. YEANOPLOS, CPA/ABV/CFF, ASA** is director of valuation services for Brueggeman and Johnson Yeanoplos, P.C., a member of the International Board of Examiners for ASA, past chair of the AICPA ABV Credential Committee and current member of the AICPA National Accreditation Commission. He has written, presented and taught on many business valuation topics.

**GUIDE TO ABBREVIATIONS**

**ABV-** Accredited in Business Valuation, American Institute of Certified Public Accountants (AICPA)
**ASA-** Accredited Senior Appraiser, American Society of Appraisers (ASA)
**BV-** Business Valuation
**CBA-** Certified Business Appraiser, Institute of Business Appraisers (IBA)
**CDFA-** Certified Divorce Financial Analyst, Institute for Divorce Financial Analysts
**CFA-** Chartered Financial Analyst , CFA Institute
**CFE-** Certified Fraud Examiner, Assn. of Certified Fraud Examiners
CFF- Certified in Financial Forensics, AICPA
**CFFA-** Certified Forensic Financial Analyst, NACVA
**CFP-** Certified Financial Planner, Certified Financial Planner Board of Standards, Inc.
**CIRA-** Certified Insolvency and Restructuring Advisor
**CM&AA-** Certified Merger & Acquisition Advisor, Alliance of Merger & Acquisition Advisors
**CPA-** Certified Public Accountant
**CVA-** Certified Valuation Analyst, National Association of Certified Valuation Analysts (NACVA)
**DABFA-** Diplomate of the American Board of Forensic Accounting
**FASA-** Fellow of the American Society of Appraisers
**JD-** Juris Doctor
**MBA-** Masters of Business Administration
**MCBA-** Master Certified Business Appraiser, IBA
**MST-** Masters of Science in Taxation
*CPA licensure designation regulated by the State of Florida •State of Maine

## COST OF CAPITAL CORNER

# COST OF CAPITAL CORNER

| | Ibbotson decile (1) | |
|---|---|---|
| | 10 | 10b |
| $R_f$ (3) | 4.4% | 4.4% |
| $RP_m$ (4) | 6.5% | 6.5% |
| $RP_s$ (5) | 5.8% | 9.5% |
| Cost of Equity (6) | 16.7% | 20.4% |

| | Duff & Phelps 25th portfolio (2) | | |
|---|---|---|---|
| | Equity | Invested Capital | Sales |
| $R_f$ (3) | 4.4% | 4.4% | 4.4% |
| ERP (7) | 12.4% | 12.0% | 10.5% |
| Cost of Equity (8) | 16.0% | 16.4% | 14.9% |

| | Inflation | Gross Domestic Product |
|---|---|---|
| Historical (1926-2008)(9) | 3.1% | 3.3% |
| 10 yr. forecast (10) | 2.5% | 2.7% |

(1) Source: Ibbotson *Stocks, Bonds and Bills and Inflation Valuation Yearbook 2009.* © 2009 Morningstar, Inc. All rights reserved. Used with permission. To purchase copies of the *Valuation Edition,* or for more information on other Morningstar publications, please visit *global.morningstar.com/DataPublications.*
(2) Source: Duff & Phelps (D&P) *Risk Premium Report 2009*, average premiums over long-term riskless rate © Duff & Phelps LLC. All rights reserved. Used with permission. Available through Morningstar: http://corporate.morningstar.com/ib and Business Valuation Resources, www.bvresources.com, and ValuSource: www.valusource.com.
(3) Risk-free rate, 20-year Treasury Bond Yield, Federal Reserve Statistical Release, 8/4/09
(4) "Risk Premium in the Market," *SBBI,* inside back cover
(5) "Size Premium," *SBBI*, pages 94 and 96
(6) Build up method illustration only; excludes industry risk premium and specific company risk, if any
(7) Report includes premiums where size is measured by market value of equity, market value of invested capital, 5-year average EDITDA, 5-year average net income, total assets, sales, book value of equity,and number of employees.Each measure for size organized by D&P, qainto 25 portfolio ranks, with portfolio rank 1 being the largest and portfolio 25 being the smallest. Smoothed average premiums are presented here because they are considered a better indicator than actual historical observation for most portfolio groups. Exhibits A-1, A-4 and A-7.
(8) Build up method illustration only; excludes industry risk premium and specific company risk, if any.
(9) Lawrence H. Officer and Samuel H. Williamson, Annualized Growth Rate of Various Historical Economic Series," www.measuringworth.com, 2009. Inflation as of 2008; GDP as of 2008.
(10) Consensus Median Average, The Livingston Survey, Federal Reserve Bank of Philadelphia, June 2009, p. 4.

*Editor's Note: I highly recommend that all financial experts who rely on Morningstar and Duff & Phelps data purchase these books/studies and thoroughly understand how the data are compiled and the data choices available.*