Jim Hitchner's Valuation Products and Services

VPS Q&A

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

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AICPA *SSVS NO. 1* CALCULATION ENGAGEMENTS

Question 1: I have a question for you on calculation engagements under the AICPA Statement on Standards for Valuation Services (SSVS) No. 1. Our firm has issued reports in the past by using two (or more) methods/approaches and then reconciling between the approaches to come to a final valuation. Is this allowable under SSVS 1 specifically for calculation engagements? In other words, can we explicitly state in our report and engagement letter that we will use a net asset approach, an income approach, and then reconcile between the two to come to a calculation of value? It seems to me if we explicitly state that is what we are going to do and agree with the client, we are still within the calculation engagement definition. Just wanted to run this by you. Thanks for your help.

Answer 1: SSVS No.1, para.21b states: "Calculation engagement- A valuation analyst performs a calculation engagement when (1) the valuation analyst and the client agree on the valuation approaches and methods the valuation analyst will use and the extent of procedures the valuation analyst will perform in the process of calculating the value of a subject interest (these procedures will be more limited than those of a valuation engagement) and (2) the valuation analyst calculates the value in compliance with the agreement. The valuation analyst expresses the results of these procedures as a calculated value. The calculated value is expressed as a range or as a single amount. A calculation engagement does not include all of the procedures required for a valuation engagement (paragraph 46)."

If the approaches and methods are in the engagement letter, which is signed by the client, then you would have agreement with the client and you would be under a calculation engagement. I would also make sure that the engagement letter explicitly states that you are performing a calculation engagement under AICPA SSVS No. 1 and even put the above quote in your engagement letter. This clearly sets the scope of services with the client and will also help to protect you and better manage engagement risk.

Answer by: Jim Hitchner, CPA/ABV, ASA, Valuation Products and Services and Financial Valuation Advisors, Inc. (Atlanta) jhitchner@valuationproducts.com.

THE RELATIONSHIP BETWEEN DISCOUNT RATES AND PROJECTED LOSSES/PROFITS

***Question 2:* What is your view of using a lower discount rate for projected losses (as opposed to projected profits), based on the assumption that projected losses are less speculative than projected profits? In a March 2005 BVR teleconference ("Discount and Capitalization Rates") it appears that you said (if I'm reading the transcript correctly) that you don't typically use a lower discount rate for projected losses. What are some of the problems with using a lower discount rate in this scenario? Thank you for your help.**

Answer 2: The discount rate should reflect the risk in the timing and amounts of the projected cash flows. I think that projections of losses can be just as difficult to project as profits or a combination. Projections are projections, whether losses or profits.

For some new thinking on the relationship between discount rates and projections see "Accounting for Significant Risk in Discounted Cash Flow (DCF) Analyses," by Todd C. Fries and J.R. Radcliffe of Business Valuation Advisors, LLC published in *Financial Valuation and Litigation Expert* journal, Issue 13, June/July 2008 www.valuationproducts.com The editors note is as follows: "The relationship between projections and the discount rate, and how to account for risk, continues to be an area of some debate. This article presents the concept of capturing risk in

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both the projections and the discount rate, particularly as it pertains to a company with significant or unique risk. May the debate continue?"

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REPORTING REQUIREMENTS, DISCOUNT STUDIES AND CHANGE OF SCOPE

The following is an exchange among Linda Trugman, Jim Hitchner, Ed Dupke and Jim Alerding.

Linda Trugman: I was hired to do a valuation engagement with a detailed report. Now all they want is a letter with the discounts to try to settle a case. Obviously, this is a change of scope, and I need an addendum to my retainer agreement. But what are my minimum reporting requirements under SSVS No. 1? I'd appreciate whatever thoughts you might have.

Jim Hitchner: Linda, read Ed's front page interview with Robert Reilly "AICPA BV Standards: The Former Chair Interviews the Current Chair" in the last issue of Financial Valuation and Litigation Expert journal, Issue 16, December 2008/January 2009 www.valuationproducts.com. Reilly says discount studies are not under SSVS.

Linda Trugman: That's interesting, Jim, but what if your original assignment was under SSVS No. 1?

Jim Hitchner: If it is a valuation engagement (and not exempt for litigation purposes) you must do a detailed or summary report, written or oral. Remember though, SSVS does not say how much to write, only what you have to disclose, and that can be shorter if you so choose. As to the change in the engagement request, that is a scope change and you are now under the new scope. See SSVS paras. 16 and 17.

Jim Alerding: I agree with Jim's responses. Jim is correct that the level of reporting is optional. However, your work papers must still support the work necessary to support the discount estimate.

Ed Dupke: My question to you is "Has the nature of your engagement changed completely?" For example, attorneys often request some basic calculation of value with a short calculation report to assist in estimating value during the negotiation stage of a transaction. They know they will need a full valuation down the road if the issue goes to trial or to tax court but in the interim they may want a calculation with the short calculation report. This is one of the scenarios that the calculation portion of the standards was intended to provide.

In your situation, are the clients or attorneys now changing the terms of the engagement? Are they really asking for minimal procedures with a one page calculation report? If this is the case, a new engagement letter may be appropriate because the engagement itself has changed.

Further, if they now only want estimated discount percentages and you are not to provide a conclusion of value or even a calculated value, your engagement clearly has changed and a new engagement letter may be appropriate. Robert Reilly and the current BV Standards subcommittee of the AICPA BV committee has ruled that an engagement to provide discount percentages only does not come under SSVS since you are not estimating the value of a business, an interest in a business, a security or an intangible asset.

This engagement to provide percentages is getting close to the edge where the standards apply. But this position is consistent with the position we have taken with fairness opinions wherein we do much of the same work we would do in a valuation but then only write a letter saying that the transaction is fair from a financial point of view. Fairness opinions are not covered under SSVS and so the same is true with opinions regarding discount percentages. The bottom line is that SSVS covers engagements to estimate value, and if you are not providing a conclusion or calculation of value, SSVS does not apply.

Jim Alerding: Ed, something in the back of my mind said that Robert had said something on this, and you have now reminded me of what. So to be certain you are saying that just providing a discount does not come under the Standard? I believe that is in fact what Robert said. Given that, then a new engagement letter may still be required because the engagement now becomes a consulting engagement only and not subject to the SSVS but the Consulting Standard #1.

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