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'Breaking Bad' in the Business Valuation Profession

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Since 2018 marks my 30th year in business valuation, I can now look back with some perspective on my chosen trade. The one overriding principle that has been reinforced to me in all these years is my obligation to provide a reliable and unbiased opinion of value. In the same way that a CPA is required to present the financial information of a company in a fair and accurate manner, reliability and independence are equally required of business appraisers. Unfortunately, the increasing use of calculation engagements seriously compromises these historical standards of reliability and independence.

In the hit drama series "Breaking Bad," a good man goes "bad" in response to a financial crisis and the need to provide for his family. Using his knowledge as a high school chemistry teacher, he becomes a major player in the meth trade in the southwestern United States. Although he makes a fortune, he also suffers severe consequences from compromising his standards. In the same way, calculation engagements (or calculations of value) also compromise the standards of reliability and independence.

By its own definition, a calculation engagement does not have to consider or properly employ the traditional and appropriate methodologies used in a proper valuation and, as such, never gets on the road to arrive at a reliable opinion of value. A calculation engagement is also subject to bias due to the client's ability to choose the methods used and thus engineer a desired value. Worst of all, the vast majority of nonappraisers do not understand the unreliability of a calculation as compared to a real valuation and may treat the two as equals. Due to these severe flaws, the terms "valuation methodology" and "valuation method" cannot be associated with a calculation engagement—these terms must be limited and abbreviated. As such, I refer to calculation engagements as "valuation meth." This article first examines the definition of a calculation engagement and then outlines the numerous problems with this synthetic and harmful narcotic.

Definitions. The rise in the use of calculation engagements began with the 2007 publication by the AICPA of its *Statement on Standards for Valuation Services No. 1* (*SSVS*). The *SSVS* allows for two types of engagements to estimate value:

> **Types of Engagement**
>
> 21. There are two types of engagements to estimate value—a valuation engagement and a calculation engagement. The valuation engagement requires more procedures than does the calculation engagement. The valuation engagement results in a conclusion of value. The calculation engagement results in a calculated value. The type of engagement is established in the understanding with the client:
>
> a. **Valuation engagement.** A valuation analyst performs a valuation engagement when (1) the engagement calls for the valuation analyst to estimate the value of a subject interest and (2) the valuation analyst estimates the value (as outlined in paragraphs 23-45) and is free to apply the valuation approaches

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and methods he or she deems appropriate in the circumstances. The valuation analyst expresses the results of the valuation as a conclusion of value; the conclusion may be either a single amount or a range.

b. **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).

As seen above, there are major differences between a valuation engagement (i.e., a real valuation) and a calculation engagement (i.e., valuation meth). The *SSVS* references 23 sections of applicable requirements for a valuation engagement (paragraphs 23-45) but only one section of applicable requirements for a calculation engagement (paragraph 46). Not surprisingly, the significant difference between the requirements for the two types of engagements results in an equally significant difference in the quality and reliability of the ultimate product.

Let's take a look at the many major problems valuation meth causes.

1. Incomplete and highly limited analysis. The first major problem with a calculation

engagement is its failure to undertake or include the necessary procedures to determine a reliable value. From the *SSVS:*

> The valuation engagement requires more procedures than does the calculation engagement. [The] procedures [in a calculation engagement] will be more limited than those of a valuation engagement. A calculation engagement does not include all of the procedures required for a valuation engagement.

Put simply, the calculation engagement is an incomplete and highly limited exercise. It is concerned only with speed and convenience and not with accuracy. It is the valuation equivalent of five minutes on WebMD versus a thorough physical exam by a doctor. WebMD may convince you that the cough and rattle in your lungs are just bronchitis, but an actual examination by a real physician may result in the far different and far more serious diagnosis of lung cancer. If you saved some money with WebMD on the front end but missed your window of treatment by not seeing a real doctor, well, I guess your spouse and children will be inheriting a slightly larger estate.

Also note that the above provisions in the *SSVS* do not specify the *degree* to which a calculation engagement is more limited as compared to a valuation engagement. Do not be fooled into thinking that a calculation engagement contains 75% or 50% of the documentation, analysis, and procedures of a valuation engagement. We have reviewed a number of calculation engagements and have yet to see one that exceeded 10%.

Jim Hitchner, CPA/ABV/CFF, ASA, is a business appraiser who is one of the four members of the original Business Valuation Standards Writing Task Force of the *SSVS*. In the September 2014 *QuickRead* (a publication of business valuation organization NACVA), Hitchner addresses the problem of the incomplete analyses and limited procedures in a calculation engagement:

> This is a big deal, particularly in a litigation setting. How does this sound? "My opinion of the calculated value of XYZ Company is $4,000,000." Sounds fine on the surface, right? Let's parse this some. What you are really saying is, "My opinion (which is sufficient, reliable, believable, and with reasonable certainty) of the calculated value (which is not sufficient, reliable, believable, or with reasonably certainty) of XYZ Company is $4,000,000. This sounds odd, as it should. So, while an opinion of a calculated value is not prohibited by SSVS No. 1, from a practical perspective, why would you want to put yourself in this untenable position?

Note the highlights of Hitchner's quote:

- "This is a big deal, particularly in a litigation setting."
- "[T]he calculated value … is not sufficient, reliable, believable, or with reasonable certainty."
- "Why would you want to put yourself in this untenable position?"

Hitchner's bottom line: *Calculation engagements are not reliable or appropriate, particularly in a litigation setting*.

Following this entirely logical and common-sense analysis of why the findings of a calculation engagement are inherently unreliable, Hitchner further addresses the unreliability of a calculation engagement when compared against the credibility requirement in the Federal Rules of Evidence, Rule 702, Testimony by Expert Witnesses:

> [S]ufficiency and reliability are major factors here. *Black's Law Dictionary*, 10th edition, 2014, defines a *credible witness* as "[a] witness whose testimony is believable." In some litigation settings, an opinion is given with "reasonable certainty." So, can a calculation and calculated value be provided that

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> is sufficient, reliable, believable, and/or with reasonable certainty? Given the language in paragraphs 21b and 77 in [SSVS], you would think that the answer is “no.”

Hitchner again is dead right on this issue—the findings in a calculation engagement are insufficient, unreliable, unbelievable, and lack reasonable certainty. And remember, *these comments are from a practicing business appraiser who was one of the authors of the* SSVS. However, despite these warnings from one of the creators of the calculation engagement, we continue to see valuation meth being used repeatedly in the litigation context.

Furthermore, a calculation engagement cannot comply with the Uniform Standards of Professional Appraisal Practice (USPAP, which Congress mandated to eliminate appraisal abuses) as it violates the most fundamental business valuation requirement of USPAP (in addition to violating a number of other sections):

> **Standard 9: Business Appraisal, Development.** In developing an appraisal of an interest in a business enterprise or intangible asset, an appraiser must identify the problem to be solved, *determine the scope of work necessary to solve the problem*, and *correctly complete the research and analyses necessary to produce a credible appraisal*. (emphasis added)

By its own definition, the appraiser does not “determine the scope of work necessary” in a calculation engagement; the client does (see Bias section below). A calculation engagement also does not “complete the research and analyses necessary to produce a credible appraisal”; it contains only a fraction of them (see Hitchner above). The implications of this are clear: *A calculation engagement does not provide a credible or reliable opinion of value.* If you find yourself on the other side of a calculation engagement, be sure to read it closely. An addled valuation meth dealer will claim compliance with USPAP. A more clever valuation meth dealer will not claim compliance with USPAP as he or she has to ignore the law he or she knows his valuation meth breaks. And, after all, it is much easier to do whatever you want when there are no laws.

Remember, a calculation engagement doesn’t require an *accurate* value, only the proper execution of the valuation methodology(ies) the client and the appraiser agreed to (i.e., dictated by the client—see next section). Do not be fooled—a reliable business valuation requires hundreds of steps, processes, and analyses—even if a calculation has its one step correct, that does *not* make it a reliable opinion of value. A properly made cake requires the proper mixing of a number of ingredients (flour, eggs, butter, sugar, etc.) and an adequate amount of time in the oven. Put just the eggs in the oven at 300 degrees for an hour, add icing and candles, and see how that flies at your kid’s birthday party.

2. Bias. A second and equally alarming problem with the calculation engagement is the ability of the client to dictate the value. According to the *SSVS:*

> 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.

Again, let’s hear Hitchner on this issue of the valuation analyst and client agreeing on the methods used (also from the September 2014 NACVA *QuickRead*):

> This is not a big deal unless you allow it to be a big deal. Most clients are unfamiliar with all the approaches, methods, procedures, assumptions, applications, data choices, etc., that make up a valuation analysis, whether a valuation engagement or a calculation

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> engagement. Let's be serious. The client doesn't ask for a calculation engagement; most don't even know what it is or that it even exists. What the client wants is a less expensive process to estimate a value. They simply want a cheaper valuation analysis.
>
> What this means is that although the client has to agree to the extent of the work performed, it is the valuation analyst who really decides what is to be done. As long as you are the one telling the client what work is to be performed, you should be able to withstand criticisms that you and the client are in cahoots and that the client is telling you what to do to drive the process and obtain a desired result. Sure, that can happen. Just make sure it doesn't involve you. The proverbial buck stops with you.

Although Hitchner undoubtedly means well, he doesn't think this one all the way through. While Hitchner is correct in saying that the client wants a less expensive valuation analysis, the client wants something else even more: *a favorable valuation result*. The ex-husband business owner who can get a $2 million calculation value on a company really worth $5 million is not nearly as concerned about whether he paid $5,000 or $10,000 in valuation fees.

Here is the reality of the situation: If the appraiser believes the market approach should be used but the client does not want the market approach used (because it will result in a value higher than the value he wants), guess what? The client will not agree to use the market approach, and there will be no mutual agreement on the methods used. While it is true that most clients are not valuation experts, most clients are intelligent enough to understand which valuation methodologies will result in a high value and which will result in a low value.

The appraiser in this case is then faced with a choice: (1) decline the project because mutual agreement cannot be achieved (and watch the client go to another, more pliable appraiser); or (2) accept the client's wishes and proceed as the client has directed, excluding the market approach. Whether it is this appraiser or the next one, the client will find an appraiser who will do what he or she wants. It is only the calculation engagement that puts the appraiser in this compromising position. In a real valuation engagement, the client has agreed in advance that the appraiser will independently determine which valuation methods are appropriate with no interference or input from the client. And remember, a calculation engagement doesn't require the appraiser to provide an *accurate* value, only to properly execute whatever valuation methodology the client wants.

So is Hitchner a Pollyanna on this issue, or am I overly cynical? Well, consider the following *actual language* in a calculation engagement we reviewed recently:

> Per your instructions, in performing the attached calculations, the "Adjusted Net Asset Method" and the "Income Method" were used.

Do you hear that? "*Per your instructions*." Not: "*By mutual agreement*." Here the truth has consciously or subconsciously bubbled to the surface. While I don't respect the use of a calculation, at least this valuation meth dealer admitted that the methods used were per the client's instructions—there was no charade that this decision was by mutual agreement. In this specific case, the ex-husband business owner dictated the use of cost and income methods and prohibited the use of any market methods. This was entirely intentional by this client due to the fact that his company had made five acquisitions of smaller companies in the last two years, consistently using a common industry formula based on revenues (which the client produced to us during discovery!). The client knew that the application of this formula to his company resulted in a much higher (and accurate) value than the calculated value under the cost and

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income methods used. Therefore, he directed the appraiser to not use the market approach. This resulted in an artificially low and totally unreliable value of the company (a value at which, incidentally, the client admitted he would never sell).

This artificially low value was the value this client and his valuation meth dealer submitted in a divorce matter to attempt to equitably divide the marital estate. It was an inaccurate and unreliable value, yet these meth heads represented to the court that it was accurate and the payment of real dollars should be made based on its purported veracity.

Lawyers often refer to calculation engagements as the business valuation equivalent of the drive-by/windshield appraisal in real estate. This is not accurate—the calculation engagement is *worse*. At least in the drive-by/windshield appraisal, a real estate appraiser or realtor makes the guess about the value of the property. With valuation meth, the *client* does the drive-by and then uses the appraiser as his mouthpiece in submitting the purported reliable value to the court.

3. Impersonating a real valuation. This leads to the third and perhaps most nefarious aspect about valuation meth: its attempted impersonation of a real valuation. Hitchner's earlier comments highlight this aspect:

> Most clients are unfamiliar with all the approaches, methods, procedures, assumptions, applications, data choices, etc., that make up a valuation analysis, whether a valuation engagement or a calculation engagement. Let's be serious. The client doesn't ask for a calculation engagement; most don't even know what it is or that it even exists.

Hitchner is right—most clients have no idea about the difference between a valuation engagement and a calculation engagement. They don't care what the report is called; they just want a value. *This is exactly what makes the calculation engagement so dangerous.* With the use of valuation software programs, a calculation engagement report can be 100 pages long and appear to be equally authoritative when compared to a real valuation report. Because of this, judges and arbitrators may believe that the value in a calculation agreement is completely accurate and reliable when in fact this value has been manufactured by the selective and incomplete use of certain methodologies whose use the client may have dictated at the beginning.

The fact of the matter is that calculation engagements are now being offered in a context for which they were never intended. The original intent of the calculation engagement was to give a business owner a "rough idea" of value (acknowledging that an incomplete analysis would be done, bias was evident, and the indicated value could be highly inaccurate). It was *never* the intent that a calculation engagement actually be used in determining a final outcome, whether that be the division of a marital estate, the assessment of business damages, the payment of gift or estate taxes, etc. Yet this is exactly what is happening with greater frequency. Clients looking for a cheap and quick way to get a number (a number, incidentally, they can influence) are making increasing use of this valuation meth to achieve the short-term high they desire.

I was speaking with another appraiser at a business valuation conference and the topic of calculation engagements came up. I said our firm simply did not do them. He admitted that he did calculations "but for settlement purposes only—I have in my engagement agreement that if the project escalates to the litigation stage, they have to get a full valuation report." I asked him why it was OK to litigate a case with a reliable number but settle a case on an unreliable number if money could possibly change hands at either stage. "But my calculations *are* reliable," he sniffed. *This is a perfect view into the mind of the valuation meth dealer.* I wanted to ask him:

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"Well, if your calculation values are always reliable, why do you ever need do a full valuation report?" I remembered, however, that addicts do not respond to logic and reason, so I held my tongue and changed the subject.

4. Meth labs. Valuation meth dealers love valuation meth because it is easier to make and is far more profitable than a real valuation. Calculation engagements require far less work than real valuations. Therefore, meth labs can charge a lower price for valuation meth as compared to the fee for a real valuation. In fact, we have seen some meth labs charge 50% of their standard valuation fee for a calculation engagement. But here's the good part: The amount of work that goes into a calculation engagement is *significantly less* than the amount of work required for a real valuation. When a meth lab charges a 50% fee for a project where only 5% to 10% of the work was performed (as compared to the 100% of work that goes into a real valuation), the profit margins of the meth lab go through the roof. As a result, valuation meth is significantly more profitable for meth labs than real valuations (which require all that troublesome and time-consuming analysis). Thus the valuation meth dealer lures his clients with: "Don't waste your money on a full valuation—all you need is a calculation."

Do not fall for the argument that the calculation engagement is "just like a compiled or reviewed financial statement instead of a full audit—it presents an accurate picture of a company's financial position, it just doesn't contain all of the tests and processes (and expense) of a full audit." This is an outright lie. The more accurate analogy is that the calculation engagement is the equivalent of the CPA preparing the asset side of the balance sheet only, totally ignoring both the liability/equity side of the balance sheet and the income statement, and presenting the final result as a reliable indication of a company's financial position.

5. Addiction. All of the foregoing factors combine to create a product that is highly addictive. The client is addicted to valuation meth due to its lower cost, the client's ability to determine the value, and the possibility that the judge or arbitrator will be unable to distinguish a real valuation from valuation meth. Which of the following options do you think the husband/business owner who wants to give his ex-wife nothing in their divorce settlement will choose:

1. Pay a higher fee for a value over which he has no control and may not like (i.e., a real valuation); or
2. Pay a lower fee for a value he can essentially dictate and may be accepted or at least be given some credibility by the judge (i.e., valuation meth)?

Not a hard decision. This keeps the demand for valuation meth high, which in turn drives supply in the form of an increasing number of meth labs. Furthermore, in addition to the client's addiction, the valuation meth dealers are also addicted due to the high profit margins and ease with which valuation meth is manufactured. These two forces feed on each other, driving valuation meth production and usage higher and higher.

6. Permanent and irreversible damage. In addition to its addictive characteristics, valuation meth also causes permanent and irreversible damage. Sadly and unfairly, however, this damage is not done to the meth user; it is done to the innocent party on the other side of the litigation. The damage comes in the form of actual financial decisions being made on a value that is both unreliable and biased. In a divorce matter, assume the ex-husband business owner orchestrates a calculation engagement with a value of $4 million by purposefully excluding a key valuation method he knows will result in a realistic, higher value for the company. The ex-wife pays for a real valuation that indicates a $10 million value. Fooled by the heft of the calculation report, the judge believes the two reports to be equally reliable and ultimately decides on a $7 million value. Here, the ex-husband has saved $3

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million in value, significantly lowering the amount he must pay to his ex-wife. Furthermore, he did this by paying a lower fee for the calculation. The permanent and irreversible damage is done to the ex-wife. She did the right thing, engaging an appraiser to provide a real valuation with an independent, supportable value. However, because the judge believed that all valuation products are created equal, he did not recognize valuation meth for what it is and the ex-wife suffered accordingly.

Before we conclude, let's take a look at some good advice and some bad advice on this issue.

Good advice. In "To Calculate or Not to Calculate: Revisiting the AICPA's SSVS-1," (September 2010 issue of *BVU*), author Nathan DiNatale, CPA/ABV, CVA, efficiently summarizes the major problems with valuation meth:

> In [valuation engagement] scenarios, valuation analysts are tasked with determining the value of the business, or pro rata share, in an objective manner, using the most appropriate valuation methods based on the company-specific information and their own valuation expertise. The resulting conclusion of value is an unbiased, undirected opinion. In such a scenario, where a third party is relying on the independence and objectivity of the valuation analyst's opinion, a valuation engagement is more appropriate.
>
> Alternatively, a calculation engagement is more appropriate when third-party reliance is not present. Calculation engagements closely resemble agreed-upon-procedure engagements, where the client retains the ability to dictate the procedures followed. [C]alculation engagements have a very limited use, in my opinion, and are not appropriate when the valuation will be relied upon by third parties, such as the fair value standards under [GAAP], estate and tax purposes in accordance with the IRS, and litigation.

DiNatale is spot-on with his analysis. Unlike Hitchner's earlier wishful thinking on mutual agreement, DiNatale recognizes the reality of the situation where "the client retains the ability to dictate the procedures followed." DiNatale also clearly and correctly states that calculation engagements are not appropriate in a number of cases, including gift and estate tax planning and litigation.

Bad advice. Contrast the clarity and logic of DiNatale's analysis with the misguided advice accounting firm Dixon Hughes Goodman (DHG) provides. In its February 2014 *Knowledge Share*, DHG offers the following opinion as to when a calculation engagement or a valuation engagement may be appropriate:

> [T]he business owner finds himself or herself involved in divorce proceedings that will require a division of marital assets. One of the significant assets is the company and a value needs to be determined. If it is early on in the process and an estimate of the value is needed to settle the matter, a calculation of value may be an option. Yet, in proceedings that will likely end up in a courtroom, it is critical to understand that the selected business valuation should attain the standards level of a valuation engagement and the analyst opining on a conclusion of value.

This is the same mush-minded rationale of the valuation meth dealer at the valuation conference I mentioned earlier. DHG is basically saying it is OK to settle the matter early on a bad number that is based on an incomplete analysis and biased methodologies, but, if you are going to trial, you better get a real valuation to figure out the true value. Where is the logic in this? In either case (i.e., settlement or trial), assets will be transferred from the business-owning spouse to the non-business-owning spouse. The goal in this process is to transfer an amount of assets that is equitable to both parties, based on the various facts and circumstances of the marriage. Why is

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it OK for this to be a bad number in settlement but a good number in trial? The only thing the calculation engagement does in the settlement stage is poison the minds of the parties by distorting the reasonable expectation of value. Why is a calculation ever useful when actual money will be transferred?

DHG then goes on to advise against the use of a calculation engagement for IRS purposes:

> The final scenario considers the business owner who would like to gift minority interests in his or her company to family members. The values of the gifts need to be determined so that the appropriate filings can be made with the [IRS]. In this case, the values that are determined are subject to the scrutiny of the IRS. As opposed to a calculated value, a conclusion of value that is obtained through a valuation engagement and provides an opinion of a valuation professional is a much stronger position to have when facing questions that may arise in an audit by the IRS.

Here, DHG gets it right—a calculation engagement simply is not suitable for IRS purposes. DHG's advice on IRS matters, however, totally begs this critical question: Why is it more important to obtain a reliable value when dealing with the IRS than in the divorce (or any litigation) context? If the IRS will not accept the unreliable and biased result of a calculation engagement, why should the parties in a divorce accept it at any stage of the process? Valuation meth is valuation meth regardless of the context in which it is used, and it should never be used in situations where an accurate value is needed or actual money will change hands.

Don't do valuation meth. Valuation meth is illegal because it breaks the long-standing and well-established laws of reliability and independence that are present in a real valuation. Valuation meth is cheap and addictive; clients love it because it doesn't cost as much as a real valuation and the client gets to control the high. Meth labs love it because the amount of work required is much lower and the profit margins are much higher than on a real valuation. Valuation meth causes permanent and irreversible damage to the innocent nonuser because individuals make real financial decisions on an artificial, biased calculation that may have no semblance at all to the true value. Worst of all, valuation meth is knowingly pushed by its dealers as a harmless, benign drug with none of the above-mentioned dangers. Valuation meth—just say no. ◆

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