



PRACTICE INSPECTION PROGRAM SUMMARY REPORT

2019

March 31, 2020

We are pleased to share this first report with Members and Registered Students containing the summary of findings of the first year of practice inspections for CBV Institute, which covered the period January 1, 2018 to December 31, 2018.

BACKGROUND

Our business valuation profession is self-regulated and its cornerstones are professional excellence and the protection of the public interest. CBVs take immense pride in their designation. Adhering to professional standards is of utmost importance. The purpose of this Summary Report is to share key practice inspection findings with practitioners in a transparent way, to fulfill our obligation to protect the public and foster implementation of best practices in the CBV profession overall.

Objectives of the Program

The objectives of the Practice Inspection Program (the “Program”) are to ensure ongoing observance of CBV Institute’s professional standards (Practice Standards and Code of Ethics), to protect the public interest, to enhance the confidence that the public and regulatory bodies have in CBV Institute, its Members and the business valuation profession generally. The Program is governed by the Mandatory Practice Inspection Policy (the “Policy”).¹

2019 Inspections

The Program became effective for work products completed on January 1, 2018 and after. As such, 2019 was the first year of the Program. Work products, as defined in the Policy, issued by practitioners, both Members and Registered Students, during the period of January 1, 2018 to December 31, 2018 (the “Inspection Period”) were inspected.

A sample of practitioners were randomly selected for the inaugural year of inspections, including both Members and Registered Students, from a list of individuals who indicated through their annual practice inspection declaration that they had issued work products. Approximately 680 members (~33%) and 100 Registered Students (~14%) declared that they issued work products subject to the Practice Standards during the Inspection Period and were therefore eligible for selection for inspection. Due to the relatively small sample size selected for this first year, results of inspections may not necessarily indicate trends. One of the main purposes of this first year of practice inspections was to help optimize the operation of the Program and prepare to scale up the sample size in future years.

Registered Students – Practice Standards and Code of Ethics

Registered Students are not precluded from issuing, signing and taking responsibility for work products, including valuation reports. **If they do so, Registered Students have the same obligations as Members to follow the Practice Standards and Code of Ethics at all times.**

Furthermore, if a Registered Student is undertaking engagements and issuing work products to clients, it is critical that they be competent to do the work. The Code of Ethics requires that a Registered Student and Member “*shall only undertake to provide professional services which he/she is competent to provide by virtue of training or experience, or is able to become competent in without undue delay, risk or expense to the client.*”²

The Institute’s professional standards apply to all Members and Registered Students, irrespective of how they sign off on reports (i.e. whether they sign off using their CBV credential, other credentials or as a firm). At all times, and especially when signing off on work products, Registered Students must refer to themselves in a way which follows the Code of Ethics. The Code of Ethics states that: “*Registered Students should disclose their affiliation with the Institute by stating that they are a Registered Student of the Institute.*”

Acceptable descriptions of affiliation with CBV Institute for Registered Students in the marketplace include:

- John Smith, Registered Student of CBV Institute
- John Smith, Registered Student in CBV Institute Program of Studies

1 Mandatory Practice Inspection Policy available [here](#).

2 The Practice Standards also require that the work be performed by a person having adequate technical training and proficiency in financial analysis and/or business valuation concepts, principles and technique, with due care...” (Scope of Work Practice Standards).

Unacceptable descriptions of affiliation with CBV Institute for Registered Students in the marketplace include the following:

- John Smith, CBV Candidate
- John Smith, CBV Registered Student
- John Smith, CBV (in progress)
- John Smith, CBV in training.

The Institute may take action for inappropriate uses of the CBV designation by Registered Students.

WORK PRODUCT SUBJECT TO INSPECTION

When do the Practice Standards apply?

The Program applies to work products which are subject to the Institute's Practice Standards, and is premised on Members and Registered Students' annual self-declaration regarding the completion of such work products. Work products are intentionally broadly defined in the Policy as:

- A. Written communications as to a practitioner's conclusion of value including schedules containing valuations where a valuation conclusion is expressed for which a practitioner took responsibility by virtue of providing them to an external user;
- B. Written communications as to a practitioner's conclusion of financial gain/loss or of a financial nature;
- C. Comments on conclusions of value, of financial gain/loss, or of a financial nature.

Given the breadth of services which business valuation professionals provide, Members are often asked to assist, advise or consult on matters where the applicability of the standards may not always be clear. Several questions arose during the annual Mandatory Practice Inspection Declaration process about whether the Practice Standards apply in certain situations, and if so, which standards apply.

In general, if the engagement requires the application of professional judgement, results in a written work product or communication where a conclusion is expressed³, and the communication is not strictly internal to the practitioner's own organization or firm, the reporting standards are intended to apply.

Practitioners are advised to consult with appropriate CBV Institute staff to discuss the specific situation of their engagements and the applicability of the Practice Standards. Guidance can also be found in Practice Bulletin No. 5 – Guidance as to when Communications are not Valuation, Advisory, Expert or Limited Critique Reports, which sets out a decision tree.

Client Consent for Practice Inspections

Confidentiality of client information is of utmost importance to the CBV profession, and the Program is carried out with highest attention to confidentiality. All parties involved, including inspectors, directors and members of the Practice Inspection Committee are required to keep confidential all information obtained. Before any file inspection can take place, clients must provide explicit consent to the practitioner to permit the Institute to proceed with the practice inspection.

In order to comply with their Member and Registered Student obligations, practitioners who sign or otherwise take responsibility for work products must advise clients in advance and in writing that work products may be subject to selection as part of a practice inspection. Practitioners should obtain express client consent to disclose the work product and related files to the Institute in order to comply with their professional obligations. This should be done at the engagement acceptance stage, ideally as part of the engagement letter. As the confidential information belongs to the client, only the client can expressly consent to their disclosure to a third party such as CBV Institute - the Institute cannot compel production of a work product where the client has not provided consent.

While clients must be appropriately advised about practice inspections, the language that each practitioner or firm will use in these communications may differ. It is important that the consent language used by each practitioner be sufficiently clear and explicit. To help practitioners comply in this regard, CBV Institute has published sample engagement letter language on the practice inspection webpage⁴. To ensure that all practitioners are seeking and obtaining appropriate and sufficient consent for practice inspection at the start of an engagement, practitioners are advised to consult with CBV Institute staff.

For the 2019 inspections, practitioners' engagement letters issued at the time of their 2018 engagements did not contain specific, informed client consent as required by the Policy. However, all inspected practitioners obtained consent "after the fact" from their clients to enable the inspections to proceed.

³ This may be a conclusion of value, of financial gain/loss or of a financial nature in the context of litigation.

⁴ <https://cbvinstitute.com/practice-inspection/>

INTERNAL COMPLIANCE/ QUALITY CONTROL PROCESSES

None of the practitioners selected for inspection for 2019 opted to rely on their firms' internal compliance review processes (also known as a quality control process). This is likely because the costs of reliance and testing exceeded the benefits of reliance, given this was the first year of the Program, and a small number of engagements were inspected.

While the Institute encourages firms to implement an internal compliance review process to internally verify compliance with CBV Institute's standards, this is not a requirement. However, it is a best practice, where the firm is of a sufficiently large size.

Furthermore, reliance on an internal compliance review process could reduce the number of work products to be inspected by CBV Institute per practitioner if any practitioners of that firm were selected. In order for Institute inspectors to be able to rely on a firm's internal compliance review process, the process must meet all of the following:

- be documented;
- have been operational throughout the Inspection Period;
- cover all of the required (bolded) elements of the Practice Standards as well as the Code of Ethics; and
- be completed by a CBV not involved with the engagement.

FINDINGS OF INSPECTIONS

Practitioners and the work products to be inspected were selected randomly. Selected practitioners included sole practitioners, those from small firms, those from mid-size firms as well as national firms. The vast majority of the 2019 inspections (80%) were conducted virtually with documents being submitted electronically using CBV Institute's secure cloud-based platform, and 20% of inspections were carried out in person at the practitioner's office. Work products inspected during 2019 included calculation valuation reports, estimate valuation reports, advisory reports, expert reports and valuation reports for financial reporting. **While overall, the 2019 inspection results were positive, there were areas where compliance with applicable professional standards can be improved.**

All inspections had findings, but the findings ranged in severity from primarily documentation, to process findings, to scope of work and reporting deficiencies. In approximately 40% of the inspections, the Practice Inspection Committee accepted the action(s) proposed by the practitioner to address the noted findings, and no further action was required. In approximately 40% of the inspections, the Practice Inspection Committee accepted the action(s) proposed by the practitioner to address the noted deficiencies, but also required some additional action by the practitioner in order to deem the inspection complete, such as for example providing evidence of implementation. Approximately 20% of the inspections required re-inspection⁵. No inspections resulted in a referral to the Conduct and Discipline Committee.

The Practice Inspection Committee's determination of the outcomes of inspections gives consideration to the comments provided by the practitioner and whether:

- Findings and deficiencies are trivial – in which case the inspection is closed;
- Findings and deficiencies are minor – in which case the inspection is closed with comments and proposed actions by the practitioner (noting both deficiencies and areas for improvement);
- Deficiencies are significant – in which case other actions are required of the practitioner, such as remedial actions, evidence of implementation, re-inspections or sanctions.

None of the 2019 inspections had deficiencies of such significance that the Practice Inspection Committee required sanctions.

The following are some of the areas of findings of the 2019 practice inspections.

Policies and Procedures for Independence and Objectivity

The most common finding of the 2019 inspections related to the lack of formal, documented controls and procedures by practitioners and their firms to ensure independence and objectivity of engagement staff and a lack of conflict of interest.

Several practitioners were unable to provide any documentation of their processes to ensure the requisite level of independence and objectivity, such as conflict checks, although all practitioners considered their independence when accepting the engagements, oftentimes through an informal process involving firm emails. However, without a documented formal process, this aspect of the inspection was difficult for inspectors to evaluate and assess.

⁵ As this first year of inspections were based on a limited sample size, these percentages are not representative, and should not be interpreted as such.

For engagements that require independence, there is an implicit expectation that processes and controls are in place to ensure this, and that the practitioner has documented these processes.

Section 401.3 of the Code of Ethics states that:

As a minimum, when providing professional services on an independent basis, a Member shall not:

- i. Hold any financial or other interest which may affect directly or indirectly the ability or reasonably perceived ability of the Member to provide such services in an independent manner;*
- ii. Contract for or accept a contingent fee or a fee based on the outcome of the matter with regard to which the Member has been engaged;*
- iii. Contract for or accept compensation for services in the form of a commission, rebate, division of brokerage commissions, or any similar form; or*
- iv. Receive any finder's or referral fees.*

The above are just minimum requirements and not a full enumeration of all possible circumstances that could reasonably lead to a perception of lack of independence. The controls and procedures in place should be reasonable and appropriate for the size of firm or office. For instance, a sole practitioner may not require many controls and procedures if they only perform engagements on a fixed fee or hourly basis and since they would readily know the investments that they hold and any personal or other type of relationship they have with the client. In this example, the documentation of the process could be fairly succinct. If, however, the practitioner is part of a multi-partner firm, the documentation of the process and the ability to evidence that the process was followed becomes even more essential. In other words, upon inspection, an inspector needs to be able to review a process which shows that the practitioner has considered all of the circumstances or relationships that might reasonably raise independence concerns.

Practitioners undertook to create policies and procedures in this regard. Some practitioners noted that policies and procedures had more recently been adopted, and in these cases they were asked to provide copies of the same. Inspectors will continue to request documentation to ensure that independence and objectivity requirements are being met.

Scope of Work, File Documentation and Professional Skepticism

The Scope of Work Practice Standards (i.e. 120, 320) require practitioners to gather “sufficient evidence” to ensure that the report and the conclusion contained therein are properly supported. For instance, Practice Standard No. 120 requires a valuation report and conclusion to be supported by sufficient evidence (based on inspection, inquiry, computation and analysis) considering the application of professional judgement by the valuator, the type of valuation report provided and its intended use. The practice standards also require key valuation components and assumptions to be considered and documented. In some situations, practitioners’ files did not contain “sufficient evidence” of the work performed on certain key valuation inputs.

While a determination of the extent of the scope and amount of work to be performed in each particular situation is necessarily a matter of professional judgement that takes into account all of the relevant facts and circumstances including the engagement agreed to between the client and the practitioner, the practitioner must be able to demonstrate to an inspector through either a) documentation in the final report or b) file documentation, the work that was performed on inputs that are significant to the conclusion.

There are several aspects to carefully consider in each engagement:

- For a conclusion to be properly supported, it must be reasonable in the circumstances. Any value conclusion, whether it is expressed in a calculation, estimate or comprehensive report, is the conclusion of the valuator, and carries with it a certain level of “assurance”;
- The consideration and documentation of “key valuation components and assumptions” is a matter of professional judgement. The standards enumerate some examples of key components, such as capitalization rates, normalizing adjustments, discounts, etc;
- How much work should be done on each key valuation component and assumption, in other words, what is “sufficient”, is also an area of professional judgement.

While the intent of the Program is not to second-guess areas of professional judgment, the inspections often identify areas where constructive feedback can be provided, and practices can be improved prospectively. The role of practice inspections is not to test or challenge a practitioner’s conclusion, but rather to assess and recommend improvements to the practitioner’s process of arriving at a particular conclusion.

It is also important to maintain appropriate file documentation to evidence the application of professional skepticism. For example, in an estimate valuation report, where a particular future cash inflow assumption in the terminal period is significant to the overall value and this input has been supplied by management, the valuation file should document the practitioner’s analysis, consideration and corroboration of this significant input. While corroboration is not strictly required for all valuation inputs, it is recommended for those inputs that have the potential to materially change the reported conclusion, and which have been provided to the practitioner by management.

Practitioners undertook to improve file documentation to evidence how significant valuation inputs were considered. Inspectors will continue to focus on the documentation of the work performed on significant inputs and assumptions.

Scope of Work – Industry and Economic Factors

Practice Standard No. 120 contains requirements for the work to be undertaken in a valuation engagement, and requires the practitioner to obtain a sufficient understanding of the relevant industry and economic environment, whether or not this information gets included in the valuation report. Par 4.1(A)(IV) and (V) of Practice Standard No. 120 require a “sufficient understanding of the relevant industry(s) in which the underlying business operates” and “sufficient information relating to the general economic conditions affecting the underlying business operations” for all estimate and comprehensive-level engagements. It encourages this for calculation-level engagements. Inspectors will assess whether this work has been documented in the engagement file. Doing work on the industry and economic factors ensures that there is adequate support for the multiples or discount rates applied in the valuation. How much work to do with respect to industry and economic factors is a matter of professional judgement, but generally ranges from low for calculation level valuations to high for comprehensive level valuations⁶. Undertaking and demonstrating adequate industry and economic knowledge underpinning the work product is especially important (and in fact required) in estimate or comprehensive level engagements, and for certain intended uses, such as matrimonial or litigation. That said, there is a distinction between report disclosure and scope of work. Under the standards, the industry and economic factors need only be disclosed in the report for comprehensive level reports.

In some cases, if a practitioner is highly experienced in a particular industry, the valuation file and analysis may not include information on the industry, and be more heavily focused on the company-specific information or factors. However, this is not appropriate – regardless of the level of valuation report provided, the scope of work should always include some level of economic and industry assessment⁷. Failure to include evidence of this work in the engagement file will result in practice inspection deficiencies, which will require remediation.

Report Disclosure – Valuations

Practice Standard No. 110 requires a practitioner to include sufficient information in the report to allow the reader to understand how the valuator arrived at the value conclusion. While the amount of information to include is inherently an area of professional judgement, there are some best practices which can be observed. For example, even in a brief valuation report, such as a calculation valuation report where the valuation is based on a capitalized cash flow method, the expectation is to explain both why the approach was applied, as well as how it was applied (including which cash flows were capitalized, at what rate, etc.)

As a best practice, the amount of disclosure provided in the report should contain sufficient detail to enable another CBV with no prior involvement with the engagement to review the report and understand the scope of work performed, the analysis and procedures undertaken, and the conclusion of value.

Practitioners undertook to improve report disclosure by including additional details about the methods selected and their application.

Report Disclosure – Key Assumptions

Several of the inspected work products contained a section titled “Key Assumptions”, as required by the Practice Standards, however, in many cases the disclosed assumptions were boilerplate in nature, such as “no material changes to the Company”, “no contingent liabilities”, “no contracts being negotiated at the Valuation Date”, etc. While these assumptions are important, the Practice Standards require “A statement of the key assumptions made in arriving at the valuation conclusion”. The intent of this requirement is to highlight to an intended user the key inputs into the final valuation conclusion provided – such as a particular future cash flow or event assumption, an assumption around costs to reproduce a certain technology, or any other item that is key to the valuation conclusion expressed. These would normally be the assumptions that, if they were varied, would cause the valuation conclusion to change by a significant amount, and may be assumptions that were provided by management or other insiders. It is important that practitioners disclose key assumptions that are specific to the valuation at hand, and not just boilerplate assumptions that could apply to any valuation engagement.

Inspectors will continue to assess whether the key assumptions disclosed in the report are specific enough to meet the objectives of the practice standards.

Draft Reports

One of the findings of the 2019 inspections deals with the issue of draft reports. The Program covers an assessment of the proper use of draft reports. It is not unusual that a draft work product may not get to a final stage for various reasons (i.e. the particular transaction in question falls through, the practitioner never receives confirmation or feedback from the client, etc). In many cases, draft work products which have been issued to clients are highly advanced and substantially complete, and are issued to clients solely for

6 This guidance is provided in Practice Bulletin No. 3.

7 Practice Bulletin No. 3 specifies that the scope of work should be “low” for calculation valuation reports, “moderate” for estimate level valuation reports, and “high” for comprehensive valuation reports.

purposes of verifying certain inputs and assumptions and to obtain the client's comments, instruction, and confirmation. However, some draft reports never end up getting finalized, and the lack of a final report could be problematic and result in unintended reliance on the draft version.

The content of draft work products are not subject to practice inspection under the Policy, primarily because they represent incomplete work that is subject to change and for which the Practice Standards do not apply. However, in order to be considered a draft work product, Practice Standard No. 110 specifies that the following four criteria must all be met:

- i. the work product is clearly marked as being in draft form and subject to change;*
- ii. the work product is issued for the purpose of obtaining comment, instruction, confirmation or other information required to complete the Valuation Report;*
- iii. the Valuator knows, or reasonably ought to know, that the intended reader(s) does not intend to rely on the work product or distribute the work product to a third party who may in turn rely on such work product; and*
- iv. the Valuator has a reasonable expectation at the time the work product is provided that a Valuation Report will be completed and issued in due course.*

Condition (iii) above may pose challenges in practice. A practitioner should make efforts to ensure that no reliance is placed by their clients on draft reports, and keep documentation of these efforts. If a practitioner is unable to demonstrate that all of the above conditions have been met, a draft work product may still be considered a final work product by the Institute, thereby making its contents subject to practice inspection. Therefore it is important that practitioners keep appropriate supporting documentation, such as cover letters or emails, when a draft work product is distributed.

The expectations of practitioners when issuing draft reports are to communicate clearly with their clients. As a best practice, the email communication accompanying a draft report should indicate:

- that the work product is a draft, subject to change, and should not be relied upon (some practitioners also use this disclaimer in their engagement letters);
- the limited purpose for which the draft report is being issued, namely to obtain comments, instruction and confirmation; and
- explicit restrictions from sharing the draft report with any third parties.

While a practitioner cannot be compelled to issue a final report if they do not receive responses from their clients on issued drafts, and there is also no requirement for a practitioner to follow up with their client once a draft has been issued, there is an implied obligation to take reasonable measures to ensure that a draft report is not being relied upon. Practitioners are advised to make efforts to communicate with their clients that there should be no reliance on drafts, and should maintain documentation and correspondence in this regard, as these may be requested as part of a practice inspection.

CONCLUSION AND NEXT STEPS

The first year of the Program constituted an important milestone for CBV Institute and a learning experience for Members and Registered Students, Institute staff, as well as the Practice Inspection Committee. The practitioners selected for inspection were highly cooperative throughout this new process.

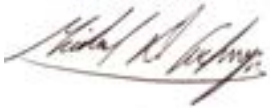
We recognize that the Policy and the practice inspection process overall will continue to be refined as we proceed. The results of the 2019 inspections showcase the benefits of the Program to the profession, and the unique learning opportunity it provides all practitioners to maintain or improve the quality of services provided. With time, as the Program continues to mature and grow, and as the number of inspections expands, we will continue to share the observations and suggestions for improvement, for the benefit of the entire CBV profession.

We look forward to continuing to evolve the Practice Inspection Program over the coming years with the objective of continuous improvement in quality for our profession.

Respectfully submitted,

On March 31, 2020

ON BEHALF OF THE PRACTICE INSPECTION COMMITTEE,



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