National Litigation Consultants' Review

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Information, guidance, and resources from the nation's leading testifying, financial experts.

UPCOMING APPEARANCES

by Members of the Editorial Board

Michael Kaplan
SEAK 16th Annual National Expert Witness Conference
Hyannis MA, June 21-22, 2007, *When Things Go Wrong: Dealing When Disaster Strikes, Marketing and Building a Premier Forensic/Expert Witness Practice: What Works*

Frederick J. Kohm
Mealey's Fundamentals of Reinsurance Litigation & Arbitration Conference
The Ritz-Carlton Hotel, New Orleans, LA
March 15-16, 2007, *Comprehensive Overview of Reinsurance*

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FEATURE ARTICLE

Current Issues: Owners Compensation, S Corps and Economic Damages

BY CHARLES S LUNDEN, CPA/ABV, CFE, CLU, FLMI, CMA

Certified Public Accountants, economists, and valuation professionals have long been able to offer assistance to attorneys in quantifying commercial damages, especially when those damages relate to a plaintiff's lost profits. Special considerations arise when the issue of owner's compensation is present, especially when the plaintiff is an S Corporation. This article will discuss issues and current cases that shed light on the controversy.

Editorial Advisory Board Comment: While the cases discussed in this article have established precedent in the jurisdictions in which heard, and in some instances statute may provide defining guidelines, the practitioner is cautioned against being bound by either of these conditions when the fact pattern of the case at hand does not "fit." In such instances it is better to offer an opinion of damages based on a sound analytical and economic foundation relevant to the facts, and then also offer an alternate value stating that "if, in the Court's opinion, precedent or statute must govern the determination of damages in this matter, then the damages (or value) would be $XXX."

Background

One of the objectives of a damage study is to provide the fact finder with economic analysis to determine an award that restores the successful plaintiff to the economic position the plaintiff otherwise

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BV FOR THE LITIGATION PRACTITIONER

Consideration of Companies With A Varying Capital Structure In The Context of Divorce

BY JAMES B. LURIE, CPA/ABV, ASA, CBA, CVA, BVAL, CIRA

A common appraisal assignment in a divorce context is the valuation of stock options granted to one or the other of the parties. Each state has different rules regarding the factors which affect the value of the options. These factors include the treatment of vested vs. unvested options; the term required to fully vest those options which are unvested; the factors surrounding the option grant (in consideration of past services, consideration for a contemporaneous act, or an incentive for future performance); and the method of valuation (intrinsic value, Black-Scholes, binomial models). Additional challenges arise when the stock underlying the options is not publicly traded and must be

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would have enjoyed, "but for" the misconduct of the defendant. Robert Dunn, in his learned treatise *Recovery of Damages for Lost Profits* (6th Edition) discusses issues related to owner's compensation in the measurement of lost profits. Mr. Dunn's treatise is an important reference book that should be a part of every damage measurement specialist's library.

Generally, "lost" profits are defined by the courts as lost revenue minus *saved costs.* These are generally not the same as GAAP gross profits as these are defined as revenues minus *costs to sell or produce.* Net profits are defined as gross profits minus overhead costs. In order to meet the legal definition, the question then becomes; "What elements of overhead - including compensation - are "saved" costs? Keep in mind, too, that these may be different depending on different production volumes, or the length of the damage period.

The issue arises when differentiating between gross profits and net profits. Some courts have held that owner's compensation ought to be considered as an element of overhead to be deducted from gross profits to arrive at net profits. Other courts have reached different conclusions on this topic.

Deductions Made for Owners' Compensation

Courts in California, Connecticut, Florida Kentucky, New Jersey, Oregon and Utah have held that the value of the services rendered by a proprietor must *be included* as overhead and deducted from gross profits to arrive at lost net profits, even if no compensation is paid to the small business owner.

The analysis becomes more difficult when professional corporations initiate suits. If a professional corporation pays all of its income to the individuals that own the corporation as compensation, can the corporation recover any damages? Courts have held both for and against recovery. In *Southern Bell Telephone & Telegraph v Kaminester*[1], the court ruled against a physician practice firm that sued when its listing was not included in the local phone directory. The court held that the failure to include the cost of the partner's services in the measure of economic harm rendered the proof of damages inadequate as a matter of law.

Anesthesiologists Associates of Ogden v St Benedict Hospital[2] follows the same logic. In this case, a group of anesthesiologists sued the hospital under a breach of contract claim. The court found that there was a breach. The plaintiffs alleged that the owners of the group suffered over $1,000,000 of lost salaries and profits. The court awarded only $15,000 in lost profits, and decided that the professional corporation must be treated as any other corporation for purposes of measuring economic harm. The court treated the unpaid salaries as saved expenses, therefore reducing the gross profits by the value of the owners' services. The court further pointed out that the hospital owed no contractual duty to the individuals, only to the corporation.

Deductions not Made for Owners' Compensation

Courts have taken the opposing view in Alaska, Illinois, Indiana, and Utah and have held that the value of the services rendered by a proprietor should *not be included* as overhead and deducted from gross profits. The decisions in *Bettius & Sanderson PC v National Union Fire Insurance Co.*[3] and also *Sisters of Providence in Washington v AA Pain Clinic*[4] are particularly illuminating.

In *Bettius*, the Fourth Circuit determined that deducting salary compensation from gross profits for a lost profits calculation would make it almost impossible to ever prove damages, create a distorted picture of corporate profits, and an injustice to professional shareholders. The court observed that an important feature of a professional corporation is that the owners are paid based on their services rendered to the corporation, and not on the basis of their ownership in the corporation. In addition, the court pointed out that the opposite ap-

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proach (allowing a deduction from gross profit) enabled the wrong doer to escape liability for his actions, simply because of a technicality in the corporate structure of the plaintiff.

Subchapter S Cases

Subchapter S corporations are in a similar quandary. How are they to demonstrate lost profits if profits are always passed through to the shareholders by way of compensation? How is a plaintiff S corporation to recover when a tort is committed? Any damage suffered by the individual shareholders would be irrelevant, because they were not injured parties, the S corporation was injured. This has been the position taken by Federal courts and state courts in Georgia.

In *Ad-Vantage Telephone Directory Consultants Inc v GTE Directories Corp.*[5], the court ruled that because S corporations avoid double taxation by passing through all income to the shareholders, that procedure results in an outcome where an S corporation always produces zero income. Accordingly, recovery for lost profit damages for an S corporation was denied.

From an economic perspective, the issue of an S corporation's ability to recover lost profit damages seems similar to that of the professional service corporation. The technicality of the corporate form of the plaintiff should not allow a tort-feasor to escape responsibility for its actions. The outcome seems inequitable. Until recently, damage measurement specialists had no cases to point to that would allow recovery for S corporations.

Impact of New Case

The recent Federal Court decision in *HC Consulting, Inc. v Goodman*[6] sheds new light on the topic. The court ruled that the application of expectancy damages would allow the recovery of lost profits for an S corporation. Expectancy damages return the injured party to the position he expected to be in, and gives him the benefit of the bargain, had the contract been performed.

Case Background

HC Consulting Inc was an S corporation that entered into an agreement with Dr. David Goodman to provide advisory and consulting services to enable Dr. Goodman to form a new business. The term of the agreement was for three years. Future Scan, the new entity formed by Dr. Goodman, was to engage in the business of acquiring and leasing scanning equipment to hospitals and other medical facilities. The scanning machines used high resolution ultrasound to enable doctors to see below the surface of the body in great detail. The business plan for the entity anticipated the placement of 150 scanners in the Philadelphia marketplace.

James McGonigle was the sole shareholder of HC Consulting, Inc. Mr. McGonigle was an accomplished entrepreneur, and had previously taken six startup companies public. After a few months, Dr. Goodman ceased paying HC Consulting, Inc. and HC Consulting, Inc. filed a breach of contract claim.

Findings

The court found that there was a breach of the contract, and that it was material. The court found that by using an expectancy measure of damages, the plaintiff was entitled to 20 months of payments at $4,000 per month. The court reduced the award by the cost to perform the contract of $963 per month. The court decided to use a 6% rate to discount future damages, relying on IRS Revenue Ruling 2006-35 Table 5.

Post Trial Motions

After judgment had been entered, the defendant moved to amend the judgment, and argued that the court had erred in not considering two of the costs that HC Consulting paid to perform the contract. Each month HC Consulting paid Mr. McGonigle $1,700 and $500 to his girlfriend, the treasurer of Future Scan. The defendant argued that these payments were saved, and should be included as a cost to perform the contract. The court was forced to consider whether owner's compensation should be included as an item of overhead to be deducted from gross profits, and whether an S corporation should be allowed to recover any profits.

The court noted there was no guidance in Pennsylvania law or in the Third Circuit. The court used the logic set forth in *Bettius & Sanderson PC v National Union Fire Insurance Co.* The court ruled that only the $500 monthly payments to the Treasurer should be deducted.

Finally, the court revised the discount rate to 4.53%, the one year T-Bill rate. (Editors note, please see Mr. Lunden's March 2004 *National Litigation Consultants' Review* article on "The Discounting of Future Economic Damages, at What Rate?")

This case will be a valuable tool to damage measurement specialists that work on damages cases where S corporations or owners compensation is an issue.

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[1] Southern Bell Telephone & Telegraph Co. v. Kaminester, 400 So. 2d 804 (Fla. App. 1981)

[2] Anesthesiologists Associates of Ogden v. St. Benedict's Hospital, 884 P.2d 1236 (Utah 1994)

[3] Bettius & Sanderson, P.C. v. National Union Fire Insurance Co. of Pittsburgh, PA., 892 F.2d 34 (4th Cir. (Va.) 1989). See also 839 F.2d 1009, 56U.S.L.W. 2485, 24 Fed. R. Evid. Serv. 1031 (4th Cir. (Va.) 1988)

[4] Sisters of Providence in Washington v. A.A. Pain Clinic, Inc., 81 P.3d 989 (Alaska 2003)

[5] Ad-Vantage Telephone Directory Consultants, Inc. v. GTE Directories Corp., 849 F.2nd 1336 (11th Cir. 1987)

[6] http://www.paed.uscourts.gov/usci2005.asp

CONSIDERATION ...

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valued. Further complications come from necessary assumptions about the continuation of employment through the vesting period. These problems can get very sticky when the option holder is not a key executive of the issuer, and when the controlling shareholders are determined to keep their financial position confidential. Often the parties simply take a common-sense approach and treat the options as being held in a constructive trust for the non-monied party, assuming that the option holder will act in his or her best interest in a decision to exercise.

As the prevalence of early-stage high technology companies grows, we expect to see a continuing increase in a relatively new issue related to options in a divorce context. In these situations, the companies have a general pattern of a continuing need for incremental investment over a period of years. This investment, typically in the form of additional series of preferred stock, is generally accompanied by additional grants of options on the common stock; without the subsequent grants, the holders of the common stock would be continually diluted to the point where their interest in continuing efforts for the company (often for base compensation lower than they would command in mature companies) would be seriously compromised. Without the additional investment, attainment of the company's objectives would be impossible.

The purpose of the incremental option issuance is not only to avoid dilution; it also serves as incentive compensation to supplement the below-market base salaries described previously. As such, options granted subsequent to a date of separation (or other "break-points" defining the demarcation of efforts within the marriage and those occurring after its breakdown) clearly constitute non-marital property of the grantee. Both these subsequent grants and the issuance of the preferred stock dilute the common stock or options on common stock held by a divorcing party prior to the date of separation. The question will be, how can that dilution and value be analyzed?

Let's start with a very simple case of dilution to show the effect. Joe owns 100% of Acme Products. Prior to his separation from his wife, he had granted his sales manager an option to buy 20% of the business for $100,000 when the Fair Market Value of the total business was $500,000. The business now has a Fair Market Value of $1,000,000, and the options remain unexercised. The options expire in two years. Joe's interest in the business is clearly not $1,000,000, because it is clear that the sales manager will exercise the options. The exercise will increase the business value by the amount of the cash infusion of $100,000, and Joe will own 80% of the $1,100,000 equity, or $880,000. The complications arise in the determination of many of the factors which are considered in a typical Black-Scholes analysis: (a) When is the likely time of the exercise? (b) How much will be paid to Joe in dividends prior to the dilution?, and (c) What is the risk (read volatility) associated with the underlying stock?

The situation can be much more complex. Joe's situation with Acme involves only one class of stock, and there is nothing in the situation which suggests the need for additional capital. Furthermore, it appears as though Acme is an established going concern.

Let's complicate the situation. Instead of Acme, the subject company is Obscure Technology Enterprises, Inc. ("OTE"). This company was formed 18 months ago as a spin-off from the physics department of the University of Southern North Dakota at Hoople.[1] The founding professors, Sven and Ollie, each hold 500,000 shares of voting common stock. USNDH holds 750,000 shares of non-voting common stock. Initial funding for OTE was provided by two venture capital firms in the form of four million shares of Series A preferred with a purchase price of $.25 per share. The stock is convertible at a 1:1 ratio. Series A holders are entitled to a preferential return equal to their investment, and then participate *pari passu* with the common until their total return, including the initial preference, equals $2.50. Upon the issuance of the Series A preferred, OTE issued Sven, Ollie, and the other employees options to purchase 800,000 common shares; none of these options has an expiration date other than the occurrence of a liquidity event. Two days after the Series A is issued, Ollie's wife picks up and leaves him.

OTE's cash burn rate is $40,000 per month, and its cash position is sufficient to last only 7 months. It will be a full year before the first prototype product is ready for field testing. Field testing will take a year, during which time the cash burn rate will increase to $100,000 per month. It is a clear that the Company will have to issue at least one more series of preferred stock, and probably two, in order to reach a point where the investment in a plant to produce on a commercial scale is feasible. The plant will require an addition $3 million equity investment.

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Finally, no one is sure the product will work, because its economic utility is dependent upon being able to extract energy from the stalks of winter wheat.

The questions the divorce court must answer are: What is the fair market value of a) Ollie's common stock[2], and b) of Ollie's 32,000 common stock options on the day his wife left? Given the future dilution and the uncertainty of success, the intuitive answer is "not much," but that is unsatisfactory to Judge Svenson.

The situation is not as far-fetched as it sounds. It has occurred regularly in every high-technology center, and as more and more locations join the technology migration, it will become as common in other locations as it is in Austin, Boston, Silicon Valley, and Research Triangle Park. Whether it will eventually reach Hoople is uncertain, but you can count on Boise.

There is no set answer to solving this complex question, and each question will be a little different. I can recommend, however, that anyone faced with this problem take a look at the AICPA's Practice Aid *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* (AICPA – 2004). While the document was designed as support for accounting compliance issues, the methodologies described, especially the Probability-Weighted Expected Return Method, provide a good framework for the rational analysis of situations where the ultimate economic returns are uncertain and fraught with risk of failure.

Explaining these models is difficult, and explaining the Option Pricing Model described in the practice aid to anyone without a sophisticated financial background may be impossible, suggesting that it probably should not be used in a divorce context. But the Probability-Weighted Expected Return Model can be presented clearly, and it can be explained. Like all models designed to estimate the future, it is inherently inexact, and probably less exact than most because of the volatile nature of the subjects to which it is applied. But it does beat the fallback answer, "not much."

Be aware, however, that the Practice Aid focuses on *accounting compliance issues.* It suggests that for financial reporting purposes a current value approach, i.e., a balance sheet method, might be more appropriate for early stage companies. In my opinion, this approach would almost always lead to a zero value for both common stock and any associated options, and is not appropriate in a litigation context.

James B. Lurie is a Principal of CapVal, LLC, providing appraisal, litigation, bankruptcy, and business planning services. He holds numerous valuation designations (ASA, CBA, ABV, CVA, and BVAL) and the CIRA from the Association of Insolvency and Reorganization Advisors. He was a senior bank lender with turnaround experience. He also held senior treasury positions with two Fortune 500 consumer products corporations. Mr. Lurie graduated from Michigan State and holds a Master's in Industrial Management from the University of North Dakota. He can be contacted at jlurie@nc.rr.com.

[1] Some musically inclined readers may recognize this institution as the home of PDQ Bach.

[2] The answer is not "If the preferred is worth a quarter, the common must be worth two and a half cents." The 10% formula was a highly inaccurate crutch adopted by many parties across the country, and it is probably only correct at a single, undefined point in the migration of a company from dream to commercial reality.

I SOLEMNLY SWEAR

"Don't Step on His Lines, Counsel"

BY THOMAS R. PORTER, CPA, ESQ., CFFA, CVA

I had been struggling to select a topic for this article as I realized the due date was rapidly approaching. Then, a gift from heaven arrived this morning in the form of a telephone call from retaining counsel, who was in complete panic mode, regarding a matter that is headed to trial in two days. The conversation went something like this:

Counsel: "You need to prepare a script of your testimony."

Porter: "OK, I'll put together an outline that will give you the question and then give me some room to roam. You'll know when to ask the next question by my inflection."

Counsel: "Nope, that won't work. I want a tight script."

Porter: "I don't do scripts."

Counsel: "You do now!"

I really detest preparing any kind of script for direct examination, and I strongly encourage you to

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DON'T STEP ON HIS LINES

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resist retaining counsel's exhortations to do so. My view is based on experience. Actually, it is based on a catastrophic experience on the witness stand. Twenty years ago or so when I didn't know any better, I prepared a script of my direct testimony for counsel. As I recall, the script was about 25 single-spaced pages long. There was no way in the world I could possibly memorize it all and deliver my answers word-for-word from the script. Unfortunately, there was no time to practice. In fact, the first time retaining counsel touched the script was as I was walking up to the witness stand.

Needless to say, he was not prepared for improvisation—and I was totally unprepared to deliver the precise testimony he was expecting. Within a nanosecond, I realized that if I did not answer a question with the exact language in the script, counsel would repeat the question I had just answered—and he would do so as though he was asking the question for the first time. I can't begin to tell you how many times I had to begin my answer with "As I just indicated…" or "As I just testified…" On top of that, counsel wasn't listening to my answers…at least until I got to the end, which he could tell by me running out of words and breath at the same time. It got so bad that at one point the judge broke in and said "Counsel, I don't mean to step on your lines, but could you please move on to the next question on your script." Oh, did that hurt!

Over the ensuing 20 years, I have come to learn that trying to script trial testimony is a recipe for certain disaster. Beyond the obvious pitfalls such as stepping on each other's lines; forgetting lines; and/or appearing to be a robot, sticking to a script causes the expert witness to focus mentally on the script with his/her eyes fixed on retaining counsel. As any seasoned practitioner knows, effective testimony comes from the heart—with attention firmly affixed on the jury.

Regarding this morning's call, late this evening I sent an outline to retaining counsel. With only one day left to prepare for trial, there are many more important issues to address than a script. Sometimes deadlines can work to your advantage.

Thomas R. Porter, CPA, Esq., CFFA, CVA is founder of TRPorter & Associates, Inc., a firm specializing in the provision of forensic accounting, economic damages analyses, federal government procurement, and business valuation services. He has testified as an expert witness before congressional committees, federal government agencies, federal courts, state courts and in arbitration proceedings. Mr. Porter is a frequent lecturer on a variety of topics involving litigation support services. He currently serves as a member of the Executive Advisory Board of the National Association of Certified Valuation Analysts. Mr. Porter can be reached via email at tomp@vcllc.com.

PRACTICE TIPS

Training Experts to Testify

BY GARY L. FREED, CPA, CVA, CFE

Before making Valuation and Forensic Services ("VFS") my full-time focus, I was an auditor. I began my career as a "Big Eight" auditor, and slowly evolved my practice from auditing to forensic accounting.

Starting in the audit area, it was easy to see the training path that you would follow. On day one you attended the firm-wide audit staff training, and continued subsequently with programmed training. Each year you could review the matrix and see what courses were on your schedule, confident that you were learning exactly what you needed in order to ascend to the next level. It was easy to train the staff and make sure they were competent, and more importantly felt competent, to do the things required of them at their current level.

Unfortunately, it is not as easy in our VFS-world. While there has been commentary concerning the courses our staff need to progress, this article focuses on a more discrete question. What courses, training and experience should potential testifiers seek so they can testify competently?

For the faint of heart or those who have not yet testified, you may want to turn away at this moment.

Testifiers must have many things going for them, including, but not limited to, intelligence, educational background, work experience, testifying experience[1] and being quick on their feet. However, all things considered, it may be that confidence is the most important attribute[2]. But how do you get experience in testifying before you testify? Sounds like a time-space continuum thing, huh?

A few experiences may prove illustrative:

My first testimony was as part of an NASD arbitration. I prepared three different times for three sessions which were held over a five-month period. By the time I finally got on the stand, I was probably a basket case. But I learned a few important lessons, including the methods of preparation that worked the best for me. Not for others, but best for me. I learned that I am a testifier who

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likes to start two weeks before I testify the same way I studied for an exam in school. The point is that you cannot teach a potential testifier how to prepare, but you can offer different approaches and let him/her develop his/her own style.

My first "Big-City" case was in the city with Broad Shoulders (Chicago). There I found myself seated at a big table in a big conference room when, all of a sudden, the attorney taking my deposition was screaming at me, pounding the table and lunging at me. My heart was racing and my brain was screaming 'where is the attorney who retained me'?

Asleep at the switch. New testifiers need to learn that in their preparation for deposition they better understand how the retaining attorney intends to conduct himself and how he/she will respond in various situations. In my case, I learned that lesson, as well as the need to immediately put on the record, "Mr. Attorney, your pounding of the table, raising of your voice and lunging at me is inappropriate." I did something very similar in a recent deposition just to make certain that any reader of the deposition transcript would understand what was going on.

Don't get me wrong, learning how to testify is a continual process and we have to educate our charges as such. For instance, they should start with more straight-forward cases and build up to the more complex ones. Their learning will be cumulative along the way. Even the most experienced testifiers must admit that they are still learning.

Recently, I testified in a case where the attorney deposing me seated me (along with retaining attorney and client) on the side of the table under the air conditioning vent. It was very cold and even though they said the problem was being corrected, the cold air never stopped. Unfortunately, I did not insist that we move to another location. By the end of my testimony I was worn out. While I still think I was able to communicate accurately and appropriately in my testimony, I became ill the next day and that illness lingered on. Our new testifiers must learn that this is not a showdown, ala "The Gunfight at the OK Corral", where the one who blinks first loses, but an opportunity to share information. If the testifier is uncomfortable for any reason — temperature, thirst, restroom needs, lighting, etc. — he/she must speak up.

So what do you do to bring your new testifiers along?

- Stress to them that they must speak in plain English to a jury or in a deposition and not use accounting-ese.
- Make certain they understand the full context of the litigation including the business context, litigation strategy, trial strategy, deposition strategy, etc.
- Make sure they are trained to not "buy bad facts" and to not get sucked into being an advocate[3]
- Teach them rules of evidence as you go along.
- Talk to them and tell them what you do when you testify, reiterating that they should feel free to mirror your methods or use them to help construct their own.
- Let them "shadow" you when you prepare for testimony.
- Find out if the retaining attorney will allow him/her to attend your deposition to observe.
- Make sure they read your previous depositions and the depositions of other experts.
- Ask if the retaining attorney will let him/her attend the opposing expert's deposition.
- Send them to deposition training courses including the sections offered by the AICPA at the National Litigation Support Services and Fraud Annual Conference, NACVA, and the IBA.
- Send them to training in public speaking and presence such as Toastmasters and Dale Carnegie[4].
- Let them be guinea pigs for law firms and consulting firms that train attorneys to take expert testimony.
- When you are working on an engagement with them, put them on the witness stand. That means when you are discussing an issue and making decisions, do some role-playing and ask them questions that emulate those of an opposing attorney.
- When they finally do get to testify, see if you can observe the testimony to offer suggestions afterwards. At a minimum, read the transcript and offer comments.

It is not unreasonable for a potential or new testifier to be so concerned about learning to testify that they question whether they have made the right decision to work in this practice area. We must help ease them into the process. As the proverb says, "The longest journey starts with but the first step." Let's help our up and coming expert testifiers take the first step and the next and the next…

The opinions expressed in this article are those of the individual author and do not necessarily represent the opinions of Clifton Gunderson LLP.

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damages, and accounting malpractice. Gary can be reached at Gary.Freed@ cliftoncpa.com or 1-800-480-5216.

[1] While it may be a circular comment, it must be reinforced that it is difficult to get testifying experience without already having testifying experience.

[2] Reference to confidence is not meant to say that mere belief in one's self is enough, but rather the confidence that comes from having the technical skills and knowledge, understanding of the process and unwillingness to adopt a position that is not supportable.

[3] The mission of the independent expert and the advocate are different. The expert must get to know the weak points of the case and prepare to address them.

[4] Accountants tend to be introverts and such training can be life altering.

BOOK REVIEW

Financial Valuation Applications and Models, 2nd Edition

BY LARI B. MASTEN, MSA, CPA, ABV, CVA

The Book

In this second edition, Mr. Hitchner brings together thirty authors to update their previous work, Financial Valuation Applications and Models, which was published in March of 2003. Hitchner has added three chapters and over 300 pages of additional information in this 2006 publication. The three new chapters are about 150 of the additional 300 pages, and address the valuation of pass through entities, strategic benchmarking, and special industry valuations.

The book has become the basis for business valuation courses offered by both the AICPA and NACVA, and was compiled to present "agreed-upon views" of the collective authors in an effort to narrow the list of controversies and disagreements that often arise in the business valuation community.

The ultimate product is a representation of the evolution of the business valuation profession and body of knowledge which addresses basic, intermediate and advanced topics in areas such as shareholder disputes, mergers & acquisitions, intellectual property, commercial damages, pass-through entities, specific company risk issues, and financial reporting. The book flows well, is easy to read, and details the views and positions on business valuation concepts, methods, and applications as seen through the eyes of the authors.

I must point out that I do not have the first edition to compare/contrast differences between editions, and at 1,368 pages, it is impossible for me to give details of the book in its entirety in a review. What I will do is highlight the features not widely seen assembled in other materials available to the business valuation community.

A very interesting and useful feature throughout the book is the prominently displayed **"ValTips,"** which clarify the specific content at hand and point out controversial and important areas of valuation theory that are often misinterpreted or overlooked. The ValTips are an easy way to 'walk' through a chapter to hit the highlights, or could be used as a refresher on a known topic or a quick review of current controversial issues. Simply reviewing the ValTips in the healthcare service business chapter, for instance, would be a fabulous prep on regulatory or revenue issues prior to returning a call for a valuation engagement of a diagnostic imaging center or physician practice.

Date specific information throughout the book has been updated. An example is the business valuation standards chapter whereby the USPAP elimination of the departure rule and the adoption of the scope of work rule effective July 1, 2006 are discussed. While this chapter of the book provides a great compendium of the **standards and requirements across the designating bodies and governing bodies**, it is not presented as a complete reference guide. For instance, IRS Notice 2006–96, which provides transitional guidance relating to the new definitions of "qualified appraisal" and "qualified appraiser" in § 170(f)(11) of the Internal Revenue Code, and new § 6695A of the Code regarding substantial or gross valuation misstatements, as added by § 1219 of the Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006) is not addressed. This omission is understandable, as Notice 2006–96 was issued post publication (November 2006). As always, be sure to reference any regulatory documents themselves when addressing specific requirements in your own valuation practice.

Very insightful addenda are presented in chapters throughout the book. These are illustrative in nature and range from descriptive – such as *Understanding Real Estate Appraisals or Machinery and Equipment Appraisals*. In light of both the USPAP Standard 3 – Review of Another Appraiser's Work, and Reliance on Third Party Experts under the AICPA's Proposed Statement on Standards for Valuation Services ("SSVS")[1], I highly recommend reviewing this feature because the addenda contain both practical applica-

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tion and visually informative presentation ideas that can be incorporated into your business valuation practice.

Also included in the addenda are **sample cases** and **checklists** - such as the *Valuation of a Hospital* or *Management Interviews for Law Practices*. The case studies present the valuation process in detail, while still telling the story of the sample case. The business appraiser can glean much guidance from the information presented in these cases including application of methods, formatting for valuation reports, reasonable approaches germane to the subject interest, and presentation of calculations. These samples include areas such as intellectual property, commercial damages, marital dissolution, FLP's, healthcare, construction, auto dealerships, radio, cable TV, restaurants, and bars and nightclubs.

Additions include the Grabowski/King research, which began in the early 1990's, in the cost of capital section. The Duff & Phelps Risk Premium Report is introduced as an emerging alternative to the traditional build-up method using Ibbotson Associates SBBI risk premia data. While the Duff & Phelps risk premium report is not new[2], its acceptance as a viable alternative to the Ibbotson build-up method is just now surfacing in the business valuation community.

The **pass-through entities** chapter is very interesting and informative, covering the controversial issues relating to whether or not there is a value premium associated with the stock in an S-Corporation as compared to stock in a C-Corporation. Four theories and the associated models regarding the valuation of noncontrolling interests in pass-through entities are presented – the Grabowski Model, the Mercer Model, the Treharne Model, and the Van Vleet S-Corporation Economic Adjustment Model (SEAM). This is a very comprehensive and useful collection of information on this particular topic.

The Workbook

The workbook is designed to be used on a stand-alone basis, and contains exercises and comprehensive answers relating to a variety of topics germane to business valuation. The exercises cover a complete valuation case study, discount case study, income approach process and a practice management workflow section. This portion of the workbook would be a very useful tool for training new staff, but would likely not be as useful to the seasoned valuation professional.

What may prove most valuable is the chapter dedicated to checklists. Many appraisers feel more comfortable with staff work when such checklists are used. A nice feature would have been to have these checklists provided as a CD in soft copy for use by the appraiser, but modification of these samples and incorporation in one's practice should prove fairly easy.

Summary

I disagree somewhat with the quoted target audience that includes appraisers, actuaries, attorneys, bankers, business brokers, stockbrokers, insurance agents, and pension administrators. The collective opinions of the authors presented in the book are designed to represent consensus on evolving issues in business valuation. As such, how can an insurance agent, an attorney, and an actuary bring from it the same impression as a business appraiser?

Regardless, the book provides a very detailed discussion of valuation approaches and methods, major risk issues, pitfalls to avoid, accounting and financial presentation issues, industry nuances, and additional references that should prove useful to all business appraisers – regardless of their level of knowledge or expertise. I highly recommend adding this reference to your bookcase, even if you have the first edition, as the second edition contains some very compelling new information that all appraisers will appreciate.

Product Information

Financial Valuation Applications and Models, Second Edition

Edited by: James R. Hitchner

Published September 29, 2006 by John Wiley & Sons, Hoboken, NJ

US $115

Financial Valuation Workbook, Second Edition

By James R. Hitchner and Michael J. Mard

Published September 29, 2006 by John Wiley & Sons, Hoboken, NJ US $55

These products can be found on many websites, and may be priced differently, including www.wiley.com, www.amazon.com, www.mbaware.com, and www.valuation products.com.

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[1] For more information on this proposed standard, see the "BV for the Litigation Practitioner" article by Thomas R. Porter, CPA, Esq., CFFA, CVA in the January 2007 issue of National Litigation Consultants' Review.

[2] First published in 1995.

TECHNOLOGY TIPS

Writing Your Reports – Let "Mikey" Do It!

BY JAMES G. ATKINS, MBA, CPA/ABV, CFE

Background

Report writers abound, and while I've never used any of them, the most popular versions are, by all reports, competitive with one another. Some have more bells and whistles, and each have their individual proponents and detractors. I want to neither offend nor promote, so will not list any of them individually. However, a trip through the vendor exhibits at the annual AICPA Business Valuation Conference, NACVA Conference, or IBA Conference will provide you with an introduction to the leading products.

These report writers are generally attached to business valuation software, and, after the numbers have been crunched, will automatically import key numerical data, both assumptions and conclusions, into the appropriate location of the report narrative.

The narrative is standard (to the product), although it can typically be customized to varying degrees. The standard language is generally adequate, although basic (as it must be since it is standardized). Therein lies problem number 1.

This publication has frequently written about the dangers of being a "dabbler," i.e., a BV or testifying expert who only occasionally ventures into these niches, or onto the battlefield where the two intersect. Unfortunately, these individuals, the "dabblers," all too often accept the finished product, and the report, from these software packages and deliver it as their own.

Ask any experienced BV practitioner who is also a testifying expert, and he/she will tell you that these standardized valuation reports can be spotted in an instant. And, when they are identified as such, they become instant ammunition for opposing counsel, and the unsuspecting "expert" his cannon fodder.

The first salvo usually begins with an innocent enough cross-examination (or deposition) question such as, "Ms. Expert, are the opinions contained in your report solely your own, and are you the only author of this report?" The expert, who "did" all the work herself, confidently replies "Yes." In court, counsel introduces a clean report (i.e., without a specific valuation target or mathematics – just the narrative) which will be, of course, word for word the same narrative which Ms. Expert testified was solely her work product.

Moving on from there, counsel will delve into the mathematics. Since the expert hasn't developed the equations utilized by the valuation software, nor dug into the code of the program, it is unlikely that she will be able to explain confidently how her opinion of value was calculated. But, that side of the problem is the topic for a future column.

The slope of Mt. Daubert is indeed slippery from there, and most who find themselves in this position will be unable to arrest a skidding plunge into the brutally, cold crevasse of *"inadmissible testimony."*

However, there are qualified practitioners who effectively and responsibly utilize such software and report writers, *but* they have customized the narrative with their own words, style, and format; and they fully understand the mathematics of the valuation side of the product. If you choose to use such products, you *must* make the investment of time to become its master (or mistress).[1]

Problem number 2 resides in the fact that there are no (at least I have never encountered any) report writers or canned analytical products for non-BV litigation engagements: damages, economic impairment, infringement, etc. One must develop one's own spreadsheets and craft an appropriate report to narrate methodologies, procedures, conclusions, and opinion(s).

Because my practice is exclusively litigation-related, problem number 2 is my primary concern. And, since I am primarily a "damages guy," I seldom am called upon to deliver an opinion based upon a full-blown business valuation. Nevertheless, on the occasions I have done so, problem number 1 has been fully in my sights. Like most of my colleagues whose practices are similar to mine, we shy away from valuation software and report writers for these reasons.

Let Mikey (your computer) Do It

So, does this mean that we must continually reinvent the wheel, slaving away with the wordsmithing of a new report for each engagement? *Au contraire, mon ami!*

"Standardized" language is a polite acronym for "boilerplate." There's nothing wrong with boilerplate, so long as it's *your* boilerplate! In fact, consistency can be a good thing when appropriate since it will illustrate that you apply the same consideration to each and every engagement (where appropriate, of course, and where facts and circumstances are similar).

Thanks to Mr. Gates and his wizards out in Redmond WA, we have at our disposal (drum roll, please) – MS

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WRITING YOUR REPORTS

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Word! (everything I'm about to discuss next is also applicable to WordPerfect although the actual keystrokes may be different). It takes only a little effort to minimize, if not eliminate, the drudgery of typing standard report language, or other required documents, e.g., Rule 26(b)(2) disclosures.

Mikey #1

Take, for instance, the required section of every business valuation report about the economy. I certainly don't research and write the national economic overview, nor do I know anyone who does. Most folks utilize one of the standard services, e.g., Mercer Capital, NACVA, BV Update, etc.; for that feature, and include it "whole cloth" or paraphrase it. In any event, disclosure is given through the bibliography or a footnote.

I use Mercer, and then do my own research to develop the economic outlook for the local region (typically Central Florida), county, and municipality. I drill down to relate the national indicators to local conditions, and so support any applicable opportunities, risks, or discount rate adjustments. Since Mercer says it much better than I could, and I frankly don't want to take the time to re-write their excellent narrative, my BV reports contain their information in its entirety preceded by this disclosure:

"The following overview of the general economy as of the X Quarter XXXX was prepared by Mercer Capital, Memphis, TN. It was considered in our evaluation of the Company's financial opportunities in the near future based on information about national economic conditions that would have been know or knowable as of the valuation date, and is presented here to assist the reader understand the economic conditions impacting the company's operations and opportunities for future growth at that time".

This section of the report is saved as a separate Word file with a name of "EconomicConditionsQtrX [year].doc". Once saved, it is usable over and over providing the valuation in question falls within the same time period, and perhaps with modification with respect to county or municipality.

You can build a complete historical library by quarter of economic conditions that can be utilized over and over in your BV reports. If you use a disclaimer, as I do, you're ready to go. If you "massage" the data you have purchased, simply remember to include an appropriate footnote with the saved file.

Any Word file previously created can be placed within another document with 3 mouse clicks. First, click on "Insert" on the main toolbar, then click "File." A drop-down menu of your files will appear; navigate to the file you want, and left click. The file will be place into your current document at the point where your cursor is residing.

Mikey #2

Frequently, inserting a saved file is cumbersome, especially if you only need a phrase or a paragraph or two. In these instances, Word's AutoText feature will save hours of work. I use this feature for transmittal letters, retainer agreements, explanation of BV approaches and methods, and a host of other things that, over the years, I've learned are said over and over in exactly the same manner.

You may have noticed the AutoText feature on the main toolbar on the drop-down menu when you click "Insert." For example, what follows is what was placed in this document when I clicked "Insert-AutoText-Mailing Instructions," and chose the selection "CERTIFIED MAIL." Note on the drop-down menu, however, that the very *first* choice after selecting "AutoText" is *also* "AutoText."

To set up your own automated text entries, boilerplate, if you will, first type the language you want (or highlight it if it already exists in a document). For example, type the following paragraph:

This letter constitutes a retainer agreement between the law firm of [ ] and [*insert your firm name*] in connection with the above-mentioned litigation. We have been retained as consultants only to assist in the determination of damages, if any, arising from alleged wrongful actions of Defendant in [*a brief description, or style, of the matter*] as of a date that you will advise; however, we understand and accept that we may be requested to furnish judicial testimony. Should a request(s) for expansion of the scope of our services be made, such request(s) will be documented by a change order to this agreement.

Now highlight the paragraph, and press "Alt+F3." A dialogue box will appear. Enter a name for this paragraph (something logical and that you can easily recall). I call mine, "dfndtdamagertnr1."

To test your work, delete the paragraph that you just typed. Then place the cursor at the beginning of the deleted paragraph, and begin to type the name you assigned to it. After a few letters (you won't have to type the entire name), you'll see the first few words of the paragraph appear with a choice to press "Enter." Do so, and your "boilerplate" paragraph will appear in your document.

Think of the possibilities!

Mikey #3

Boilerplate that has dates in it can be kept current with the use of *fields*. For instance, if your document contains a date that is relative to the date the document is being prepared, insert {DATE \@

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WRITING YOUR REPORTS

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"MMMM d, yyyy"} (to insert a field, type "Ctrl+F9," then right-click, and follow the prompts). The field code may appear in your document, but the appropriate contents will appear when your document is printed – to see the content in your document, toggle by pressing "Alt+F9." View all the choices under "Edit Field Codes" to see the type of items that can be automatically updated in your document. Be careful, though, if you need to save a copy with only the current date, remove the field before saving the file. ***Otherwise, when next opened, the date field will convert to the then current date.***

Mikey #4

Templates, fields, and mailmerge can be combined to create powerful time savers. The process is a little complex, too much for this article, but not overwhelming. All it requires is that you either "read the manual" in print or at the online Word help center. For example, I have created a process whereby our conflict engagement form, when complete and approved, automatically fills the appropriate information for our engagement letter. In a similar manner, I maintain both my publications and cases in an Access database, and can produce an updated Rule 26(b)(2) disclosure with respect to those items with just a few mouse clicks.

Summary

Report writers have their pitfalls. As experts, our opinion and work product is supposed to be ours alone or ours with the collaboration of fully disclosed staff. However, with a little forethought and a moderate degree of effort, you can streamline your report writing and many other administrative tasks associated with litigation engagements. "Boilerplate" is only standardized language, and so long as it is your standardized language, it is acceptable.

Simplify your life. Let Mikey do it.

Jim Atkins is Senior Editor of National Litigation Consultants' Review, a nationally recognized speaker, and the founder of two, successful CPA firms. He has been active in business valuation and litigation support since 1991, and practiced exclusively in this niche since 2000 as the founder and Managing Director of Economic Forensics, LLC. He has served as an expert in more than 100 multi-million dollar disputes. Jim limits his time now to litigation consulting, writing, public speaking, and mentoring firms in the development, marketing, and administration of their litigation support practices. He can be reached at jim@economic forensics.com.

[1] The IBA will automatically disqualify any submitted demonstration report if the review detects that it has been prepared from an unedited commercial report writer.