

The Witness Chair

Cutting-edge Ideas for CPA Experts Providing Litigation and Dispute Resolution Services

WINTER 2004

ISSUE 33

Software Companies: Important Considerations in Determining Value

by James S. Rigby, CPA

Everyone uses software today. It has permeated every aspect of our lives and as valuation and litigation experts, we often need to understand the software industry. This is a daunting task considering the industry is made up of multiple segments and is geographically fragmented throughout the United States.

A recent analysis of the first quarter of 2003 merger and acquisition data shows that software companies have sold for prices ranging from 10 percent of sales to more than 10 times sales. Differences in profitability alone are not likely to account for these pricing differences.

Digging deeper exposes some causes for the value differences among software companies.

The industry is generally divided into four distinct groups:

1. *Providers of packaged software applications*—Provide completed software programs that may be used with minimal or no modifications.

2. *Custom developers*—Develop custom programs for other companies to meet specific criteria established by the purchaser.

3. *Information providers*—Maintain databases primarily through the Internet and are software dependent for customer contact and provision of services.

4. *Pure play Internet companies*—Companies that are totally depen-

dent on the Internet for all sales and are software dependent for customer contact and provision of services.

This article focuses on providers of packaged software applications. Software company valuations typically use the same valuation techniques as used for non-software companies. A quick review of the three valuation approaches highlights some of the general concepts and associated issues:

1. *Asset-based approach*—This approach is seldom used in valuing software companies except in cases involving a company's liquidation. Intangible assets make up the core value of a successful software company and cannot be valued without using an income-based approach.

2. *Market-based approach*—Public company multiples are commonly used, but focus on price to revenue and price to EBITDA multiples. Even with these multiples, most investment bankers working with software companies take a lack of comparability discount to public companies of at least 50 percent. This makes the method very subjective and of minimal value.

Private company multiples can also be used, but the lack of data to do a comparability analysis makes these methods questionable. If used, they normally focus on the same multiples used for public companies.

3. *Income-based approach*—The capitalization of earnings method,

popular with many valuation experts, suffers from the economic effects of the short life cycle of software. In addition, it fails to capture the highly volatile change in growth rates of software companies due to their typical dependence on one product with a short life cycle.

The discounted cash flow (DCF) method is the most common method used in the industry, but it also has problems. The major software investment banking firm in the country focuses on this method and teaches that the discount rates typically used in the DCF model start at 30 percent.

For a more in-depth look at how to value a software company, download the article "What's my Software Company Worth" at www.fvginternational.com/software.

Valuation experts need to understand the unique characteristics of the software industry. Our firm has identified 16 unique characteristics we believe work. The two most important are:

Continued on Page 5

In this Issue

- Section Action Page 2
- Message from the Chair Page 3
- Keepin' It Legal Page 4
- AICPA Alert Page 5
- Happenings Page 6

Section ACTION

Business Valuation

by Stephen D. McMorrow, CPA

In the last issue of *The Witness Chair*, David Helms and John Toney wrote about developing the discount rate used in a business valuation. Helms and Toney wrote that the rate typically includes: 1) a risk-free rate, 2) an equity risk premium, 3) a size element, and 4) a specific risk adjustment for the subject investment, also known as company-specific risk adjustment.

As a follow-up to the company-specific risk adjustment discussed in the column, it is important to note that empirical data will not be available in many situations and the appraiser must determine the company-specific risk adjustment in a subjective manner. In the July issue of *Business Valuation Update*, an article by Bryant Finison and Michael Daily noted that very few sources have set forth a reasonable range for the company-specific premium.

According to PPC's *Guide to Business Valuations* (Guide), the company-specific premium for a small business will range from 3 percent to 15 percent, although adjustments may be significantly greater than 15 percent for some high-risk businesses or even negative for companies with lower risk than the average small company. The Guide notes that Shannon Pratt has recommended that the reasonable range may be as low as negative 2 percent to as high as 5 percent, with premia exceeding 5 percent for companies with inherent problems. Such risk premia may begin to approach venture capital return rates. Finison and Daily state that their model resulted in premia between 2 percent and 6 percent for businesses exhibiting moderate to strong profitability and lacking any extreme or strategic characteristics.

After establishing the range, the following issues should be considered in determining the premium to apply: financial condition; competition, management depth and reliance on key people; access to capital resources; size and geographic diversification; customer diversification; reliance on vendors/suppliers; work force stability; management systems; and any other factors peculiar to the subject that would affect the level of risk.

Stephen D. McMorrow, CPA, CBA is the partner in charge of business valuations at McMorrow Valuation Partners, a division of Bratton, McMorrow & Kearney, LLP in Ventura.

Economic Damages

by Christian Tregillis, CPA

After *A&M Records, Inc. vs. Napster, Inc.*, 239 F.3d 1004 (9th Cir. 2001), it seemed the recording industry had won, shutting down the popular peer-to-peer file sharing service due to the fact that it tracked copyrighted material that was being downloaded for free.

But the pirates returned, heeding the Electronic Frontier Foundation's (EFF) suggestion that it was better "to sell stand-alone software ... than ongoing services. A disaggregated model ... may limit what a court can order you to do to stop infringing activity by your users." Kazaa, the leading file-sharing service after Napster's shutdown, built an intricate infrastructure with interests in Estonia, Denmark, Australia, and the island nation of Vanuatu. But it was found to have enough U.S. activity to be subject to U.S. jurisdiction.

Still, in *MGM Studios, et al. vs. Grokster, Ltd., et al.*, 259 F.Supp.2d 1029 (C.D. Cal. 2003), Judge Wilson ruled that the new services had overcome the problem that doomed Napster. After downloading the new software, users query each others' machines for files without going through the software provider. Since the software provider is unaware of what is shared, Judge Wilson ruled it cannot be found liable.

The Recording Industry Association of America (RIAA) then began filing suits against individuals and won a trial court ruling in January 2003 to obtain the names of individuals from ISP Verizon. But in December 2003, the ruling was overturned, with the court saying that the Digital Millennium Copyright Act, under which the RIAA made its claim, was created before the piracy issue had surfaced and was thus not available. The RIAA insists it will continue going after the individuals and a further appeal is expected.

Additionally, in the *Aimster Copyright Litigation*, 334 F.3d 643 (7th Cir. 2003), Judge Posner reached a different conclusion from Judge Wilson, stating that "[e]ven when there are noninfringing uses ... if the infringing uses are substantial then to avoid liability as a contributory infringer the provider of the service must show that it would have been disproportionately costly for him to eliminate or at least substantially reduce the infringing uses."

The ruling on the *Grokster* appeal is expected early this year and tension between the rulings by judges Wilson and Posner calls for reconciliation. Even if the ruling is overturned, it appears that only two things are certain—file sharing and more litigation.

Christian Tregillis, CPA, ABV is a partner in Deloitte & Touche's Dispute Consulting and Forensic Investigations practice in Los Angeles.

Family Law

by David S. Cantor, CPA

The majority of family law cases involve the determination of the parties' Gross Cash Flow Available For Support (GCF). This calculation is done to assist in the determination of temporary and permanent support.

Some professionals are under the misconception that the calculation is as simple as taking the numbers from the parties' income tax returns. Without detailing this methodology's numerous problems (phantom income, perquisites, principal pay

down on investment property mortgages, etc.), there are some general considerations when presenting a GCF calculation and dealing with inconsistent streams of cash flow.

While courts often tend to look at the last 12 months of GCF as a proxy for the future, the last 12 months of GCF is often not indicative of the next 12 months. Reasons for this include nonrecurring items such as bonuses, fluctuating commissions, extraordinary repairs, or major purchases. The CPA needs to identify all of these issues, quantify the amounts, and determine the most effective way to present the results.

The presentation of the GCF report may depend upon counsel's legal strategy. One option may be to include multiple scenarios of GCF in the presentation. For example, one column may present the actual historic earnings for the last 12 months and other column(s) may show what the anticipated GCF is after making adjustments for nonrecurring items or other relevant changes. This provides the court with all of the information and allows the judicial officer to make an informed decision.

David S. Cantor, CPA, ABV is chair of the Family Law Section and a partner at Gursley, Schneider & Co. LLP in Los Angeles.

Fraud

by Everett P. Harry, CPA

Joe Anastasi is a recognized litigation services practitioner in California and currently heads an international CPA firm's forensic investigations practice. His new book, *The New Forensics: Investigating Corporate Fraud and the Theft of Intellectual Property* (John Wiley & Sons, Inc., 2003), is well-researched and engaging. The book will provide practitioners with timely information about litigation services, particularly fraud investigations.

The book begins with a "raid" on the computers and documents of Morgan Fay, a fictionalized company, and describes the personal and professional challenges that arise to unravel and reconstruct a complex financial state-



Message from the Chair

by D. Paul Regan, CPA

Our most recent steering committee meeting covered several issues impacting the practice of litigation services, including 1) the AICPA's *Proposed Statement on Standards for Valuation Services* (BV Standards), 2) the AICPA's proposed Family Law Practice Aid, 3) the AICPA's proposed Engagement Letters Practice Aid, and 4) a presentation on electronic data mining by John Lam of Hemming Morse, Inc., CPAs.

Our section members are playing an important role in monitoring and participating in the development of the AICPA's standards and practice aids. We hope that these materials can become effective tools for practitioners. I applaud the passion and dedication that our volunteers invest toward the goal of producing the best possible standards and practice aids for our profession.

Now that the AICPA Council has voted to continue to support the ABV credential, the BV Standards take on even greater importance. Our members participated in reviewing this document and our steering committee sent the AICPA

a letter with a number of comments on content. We have had some success, however there continues to be resistance to including a section that identifies areas in which litigation services differ from valuation services. This is not a new concept. The AICPA's 1985 *Statement of Standards for Accountant's Services on Prospective Financial Information, Financial Forecasts and Projections* includes a litigation exception.

An example of the tension between the BV Standards and a litigation engagement is that the BV Standards state that they apply to "the act or process of preparing an indication of value based on assumptions, approaches, and procedures agreed upon with the client." This appears to include many economic damages engagements.

The steering committee will continue to work with the AICPA to resolve these and other issues and will keep you posted as to when the BV Standards will be released for comment.

D. Paul Regan, CPA, CFE is president & chair of Hemming Morse Inc., CPAs, Litigation and Forensic Consultants in San Francisco.

ment fraud. Then, educational perspectives are provided about Enron, WorldCom, and other accounting scandals, as well as the electronic investigation techniques used to locate Holocaust victims' monies in Swiss bank accounts and to find and dispose of Pablo Escobar.

Books about financial statement fraud are not new. In the late 1970s *The Equity Funding Papers: The Anatomy of a Fraud* and *Computer Capers* addressed similar topics. What is "new" over the last 30 years is the proliferation of personal computer use by

individuals and corporate employees, the infinity-approaching e-mail trail, and the power and complexity of company hardware and software systems. Anastasi provides insights about electronic techniques and old-fashioned document reviews used to reverse engineer a fraud.

If you work in the area of fraud detection, keeping current on such related reading material is crucial.

Everett P. Harry, CPA is a past chair of the Litigation Sections and founding partner of Harry-Torchiana in San Francisco.



Fiduciary Duty: Lessons Learned

by Garrett C. Dailey, Esq.

Fiduciary duty will be the single most important issue for family law attorneys and forensic accountants in the coming years. We will no doubt learn many lessons as we continue to explore the parameters of this duty.

Redefining Marital Duties

The concept of spouses being fiduciaries is not new in California [*Fields v. Michael* (1949) 91 Cal.App.2d 443, 205 P.2d 402]. However, since the redefinition of marital duties in 1992, it has taken on a much more prominent role in marital dissolutions. *Marriage of Haines* [*In re Marriage of Haines* (1995) 33 Cal.App.4th 277, 297, 39 Cal.Rptr.2d 673] was one of the first important fiduciary cases of the modern era and held that a presumption of undue influence arises anytime one spouse obtains an advantage over another in a community property transaction. As applied in *Haines*, the presumption favored the community. Most family law attorneys did not pay much attention to the role of fiduciary duty in such situations—at least until *Marriage of Delaney* [*In re Marriage of Delaney* (2003) 111 Cal.App.4th 991, 999, 4 Cal.Rptr.3d 378] applied the *Haines* presumption to defeat a transfer that favored the community.

Although *Delaney* was not revolutionary, it was evolutionary and highlighted that the advantaged spouse must be able to show that the transaction was:

1. Freely and voluntarily made,
2. With full knowledge of all the facts, and
3. With a complete understanding of the effect of the transaction. If the spouse cannot, then the interspousal transaction could be set aside.

Does this mean that all transactions between spouses are void? Of course not. All, however, are vulnerable to the presumption of undue influence. But presumptions may be overcome when the evidence supports a finding that the transaction was freely entered into by the parties with a general understanding of its effect. In *Marriage of Friedman* [*In re Marriage of Friedman* (2002) 100 Cal.App.4th 65, 72, 122 Cal.Rptr.2d 412], for example, the wife's challenge to a postnuptial agreement as a breach of fiduciary duty was easily dispelled.

Lessons Learned

Seven lessons learned from the fiduciary age are:

1. *All interspousal transactions may be scrutinized*—While all interspousal transactions may be scrutinized, they will not all be set aside simply because they were between unrepresented parties who failed to observe the myriad of legal niceties that competent lawyers would have interposed. Understanding that different judges will interpret and apply the fiduciary standards differently to interspousal transactions, most will examine the transaction to ensure both spouses were aware of the general effect of the transaction and that neither took unfair advantage over the other. In the common situation where the other spouse's name is added to a deed in a refinance, *Delaney* will be raised as a defense by the transferor in virtually every case. In most situations, if the trial judge believes that the transferor understood that by putting the other spouse's name on the deed the spouse was granting the other an ownership interest in the residence

and did so willingly, it is doubtful that the transaction will be set aside simply because the spouse was unaware of the exact parameters of that decision.

2. *Disclose the details of assets and obligations during dissolution*—Failure to disclose the details of assets and obligations during dissolution will lead to undesirable consequences. *Marriage of Brewer and Federici* [*In re Marriage of Brewer and Federici* (2001)

93 Cal.App.4th 1334, 113 Cal.Rptr.2d 849] held that spouses have a duty to acquire and disclose relevant financial information that is available to them,

even if no formal discovery requests are made, as outlined in Family Code Sec. 2100. The consequences of the failure to meet this duty can be the setting aside of the entire judgment.

3. *Legislative intent: adequate disclosure*—The legislative intent is that information regarding the community's finances be equally available to both spouses during marriage. Although Mr. Duffy dodged a bullet when he failed to adequately disclose the family's financial information to his wife during marriage [*In re Marriage of Duffy* (2001) 91 Cal.App.4th 923, 933-934, 111 Cal.Rptr.2d 160], SB 1936, Sec. 2, eff. Jan. 1, 2003, amended Family Code Sec. 721 to make it clear that it wanted full disclosure on request. What is not clear is what the remedies will be after separation for the failure to provide information upon request during marriage.

4. *Attention to legislation is necessary*—There are limits beyond which the Legislature is not presently prepared to go. After *Marriage of Duffy* held that spouses are generally not bound by the Prudent Investor Rule and do not owe the other the duty of care one business partner owes to another, attempts were made to amend Family Code Sec. 721 to include that duty. The Legislature

Continued on Page 6



by Jeffrey H. Kinrich, CPA

The Forensic and Litigation Services Subcommittee (FLS) met in Miami last fall immediately preceding the AICPA's annual Litigation Services and Fraud Conferences.

Anat Kendal of the AICPA described how the AICPA is moving to provide more direct, relevant assistance to members.

The FLS strategic plan was discussed. The discussion revolved around the plan's three major elements: education and content, communication to CPAs, and external outreach. The content element has four major sub-sections: one each for the three major practice areas (Fraud, Economic Damages, and Family Law) and one focused on the process

of how forensic and litigation consulting is conducted. Progress is being made in each of these areas.

There are active plans for developing and updating several practice aids. A practice aid on Engagement Letters is expected to be published early this year. Practice aids on Family Law, Intellectual Property Damages, and Conflicts of Interest and Independence are also in the works. The portions devoted to independence are being developed in conjunction with the AICPA's Professional Ethics committee with the help of Mike Ueltzen. In the fraud area, a white paper on *SAS 99: Forensics in the Audit* developed by Ron Durkin is being published, and a joint webcast with the AICPA and the FBI took place in November 2003.

Plans for FLS content on the AICPA website were discussed. The intent is to have links to substantive articles, reference materials, and other relevant sites, as well as to provide marketing assistance, relevant news, and current events. The hope is that

the site will be up and running by early this year.

The 2003 AICPA Forensic & Litigation Services Volunteer of the Year Award was awarded to two individuals, both of whom we know well. Ron Durkin and Mike Ueltzen were the overwhelming choice for this first-time award. Several of the factors considered in the selection include a positive impact on the profession, contributions to the body of knowledge, leadership role in education or training, and enhancing opportunities for CPAs in the profession.

All of us in the forensic and litigation services consulting arena benefit from the contributions Mike and Ron make to our profession. We are honored they are part of the Litigation Sections, and we congratulate them on receiving this award.

Jeffrey H. Kinrich, CPA, ABV is a managing principal in the Los Angeles office of Analysis Group, an economic and litigation consulting firm.

Software Companies

Continued from Page 1

1. *Economic scalability*—All of the cost of developing software is imbedded in the first product. Today, with the electronic distribution of software, the product cost of additional sales is almost nonexistent. The economic effect is a rapid increase in the gross profit margins as the company increases its sales volume. This is why software companies often are considered to be marketing companies once they reach any critical mass in their sales/user base.

2. *The short life cycle*—Software is normally considered to have an economic life cycle of 12 to 24 months. Generally during the 12 to 24-month period, unit sales begin to decline. This places extreme importance on developing new versions of a product and marketing the sale of upgrades. As a product matures, this becomes increasingly difficult, increasing the company's risks.

As a result of the short life cycle, discussions have begun in the industry on how to develop recurring revenue streams. Most people believe that the industry will move toward the annual licensing of software (e.g., Microsoft's new licensing agreement is a movement in this direction) and to online application service providers who charge a monthly fee, as salesforce.com successfully does.

The difference in the pricing multiples of software companies is primarily the recognition of differences in the "value enhancers" that characterize each company.

These value enhancers can be divided into four categories:

1. *Product oriented*—Research budget, user and developer documentation, experienced R&D team, patents and copyrights, technology, and size and quality of user base;

2. *Sales and marketing oriented*—Pricing support, distribution channels, competition, replicable sales

process, growth in the size of the marketplace, and marketing alliances;

3. *Finance/economic oriented*—Business model, record keeping, company position in the marketplace, ownership structure, accounting policies, and profit margins; and

4. *Management oriented*—Communicable vision, experienced management team, planning process implemented, and firm appropriately staffed.

Because of the impact these value enhancers have, it is difficult to compare software companies and understand their future without substantial qualitative analysis of each company, its specific market, its industry, and its competition.

Jim Rigby, CPA, ABV, ASA is a managing director with the Financial Valuation Group. He specializes in valuations, expert testimony, and consulting for software and high technology companies, and is a member of the AICPA's Business Valuation Hall of Fame.



H A P P E N I N G S

Litigation Sections Meetings

Business Valuation	Thursday, Feb. 5, LAX Thursday, May 13, North Thursday, July 22, LAX Thursday, Sept. 16, North
Economic Damages	Wednesday, Feb. 25, LAX
Family Law	Friday, Feb. 6, LAX Friday, May 14, North Friday, July 23, LAX Friday, Sept. 17, North
Fraud	Tuesday, Feb. 24, LAX

Each section will send individual meeting notices.

**Education Foundation Course Offerings—(800) 877-5897
or www.educationfoundation.org**

Keepin' It Legal

Continued from Page 4

rejected that request and made it clear that it was not imposing that duty on spouses (see "Prudent Investor Rule Does Not Apply to Investment Decisions Made During Marriage—Yet," *State Bar Family Law News*, Summer 2003, Vol. 25, No. 3, p. 5).

5. *Disclose intent to sell investments*—Spouses are not going to be held liable for the failure to know when to sell. A corollary to the previous lesson is that the values of investments go up and down. If the nonmanaging spouse wants to sell his or her share, whether before or after separation, then he or she must file a motion to do so [Family Code Sec. 2108 and Family Code Sec. 1101(b)]. A verbal request or letter demanding they be sold generally will be insufficient to trigger any sort of liability for the loss on the managing spouse [*In re Marriage of Reuling* (1994) 23 Cal.App.4th 1428, 1435, 28 Cal.Rptr.2d 726].

6. *Postseparation investment opportunities*—Postseparation investment opportunities are going to be

scrutinized. Family Code Sec. 2102 (Sec. 2102) requires that any financial opportunities that result from marital activities be offered to the other spouse in writing in time to make an informed decision as to whether he or she desires to participate and for the court to resolve any resulting disputes on pain of having the gain from any such activity treated as if it were an undisclosed community asset.

A recent case limited the period of liability as ending upon the division of the asset from which the opportunity traced [*In re Marriage of Hixson* (2003) 111 Cal.App.4th 1116, 4 Cal.Rptr.3d 483]. Sec. 2102 is impractical and unwieldy in that few financial opportunities last long enough to permit a spouse to give sufficient notice before electing to participate. Strictly interpreted, the profits made by any spouse making such an investment could be ordered divided as an undivided community asset. Hopefully, the appellate courts will engraft a reasonableness limitation on the statute. However, even if this happens, this area must be examined.

7. *Investment opportunities during marriage*—Investment opportunities

that occur during marriage also are going to be scrutinized. Advocates of strict fiduciary duty are pressing for a rule whereby the managing spouse will be strictly liable to the community unless he or she obtains written authorization for every investment, whether separate or community. Hopefully, a reasonableness standard will be applied here as well.

One prediction is safe—there will be an appellate opinion in the near future that will wrestle with this thorny issue. This area of law is going to develop quickly over the next few years. Sit back and enjoy what is certain to be an interesting ride.

Garrett C. Dailey, Esq., CFLS is co-author of Attorney's BriefCase California Family Law, author of SupportTax and co-author of Lawgic Marital Settlement Agreements and Lawgic Premarital Agreements. His practice is limited to appellate work, consultations on complex issues, expert witness work, and drafting property agreements.

The Witness Chair is published quarterly by the Litigation Sections of the California Society of Certified Public Accountants.

Editor

Susan Bleecker

Associate Editors

Leslie Dawson

Maria Nazario

Sections Chair

D. Paul Regan

Individual Section Chairs

Business Valuation Rob Wallace

Economic Damages Troy Dahlberg

Family Law David Cantor

Fraud Ron Durkin

CalCPA Staff Liaison

Maria Nazario

Nonmember subscription rate is \$75 for one year. To subscribe, call CalCPA at (818) 546-3502 or (800) 922-5272.

We welcome your letters, articles, comments and suggestions, which may be sent to the editors at bleeck@pacbell.net.



The Witness Chair does not provide legal advice. The material published, unless otherwise specified, represents the views of the authors and the individuals quoted and not those of CalCPA or the AICPA.

California Society Certified Public Accountants

www.calcpaexpert.org