THE Witness Chair

Leading-edge Ideas for CPAs Providing Litigation and Dispute Resolution Services

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The Quest for Comparability
Brings Diversity

by John M. Lacey, CPA
and Richard S. Barnes, CPA

Today's challenge to compare financial statements across companies and across time is growing. Changes in financial reporting standards, and the transitions and options that accompany those changes, require extra care to ensure that information is really comparable. Fair value is becoming more common in financial reporting and a new standard has brought consistency to the definition of fair value. The use of fair values means current reporting may not be consistent with past reporting—and use of fair values is in some cases optional.

Old Problems

Analysis of financial information is at the very core of much of the work CPAs do, particularly in litigation consulting and business valuation. Analysis is often split into two broad categories—time series and cross sectional. Time series analysis compares information about the company over time. Cross sectional analysis compares the company to industry statistics or to information about specific companies. While the purposes of the analyses may vary, it is important to compare information in ways that can lead to meaningful conclusions.

In both types of analysis, especially cross sectional analysis, it has always been difficult to determine whether the financial information being analyzed for the companies is really comparable. This is particularly true when we have access to only limited information about the companies being compared.

For example, Company A (subject company) is a retailer, where the management of inventory is critical. Company A reports its inventory on a LIFO basis. A's inventory varies significantly throughout the year and at year-end the inventory is at one of the lowest levels during the year. Company B (comparable company) reports its inventory on a FIFO basis, with its year-end inventory at one of its highest levels during the year. These differences, without adjustments, could have a dramatic impact on the comparative ratio analysis between A and B, including liquidity, activity, leverage, profitability, rate of return and growth, which could likely lead to faulty conclusions.

New Standards

New accounting standards have brought with them new problems in making comparisons. Several recent accounting standards issued in the United States require or allow fair value reporting instead of historical cost, which makes historical comparisons difficult because the measurement scale has changed. It also means that the reader has to be careful, even when making current comparisons, to understand which measurement scale is being used when alternatives are acceptable. Part of the motivation for the change to more fair values is the FASB's move to harmonize with International Financial Reporting Standards. There is even more use of fair values in financial statements prepared in accordance with IFRS.

FASB Statement 157, issued in September 2006, creates one consistent definition of fair value. It does not require the use of fair value measurements in any new circumstances, but does create a hierarchy of fair value measurements and requires new disclosures. This is the place to look to understand how the term "fair value" is to be used and how fair value measurements are to be made. Following the issuance of Statement 157, other statements have moved to require or permit accounting based upon fair values.

Statement 158 requires companies to recognize the funded status of a benefit plan—measured as the difference between plan assets at fair value, with limited exceptions, and the benefit obligation—in its statement of financial position. For a pension plan, the benefit obligation is the projected benefit obligation; for any other post-retirement benefit plan, such as a retiree health care plan, the benefit obligation is the accumulated post-retirement benefit obligation. This new value is closer to a fair value of the liability than what was reported before and is important because it caused a significant change in the reported amount of benefit plan liabilities reported on many companies' financial statements. Comparisons across time should acknowledge the changed measure for those plans.

Statement 159 allows companies to choose to measure many financial instruments and certain other items at fair value. The statement provides companies with the opportunity to measure related assets and liabilities on the same basis, thereby

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Section Action

Business Valuation

by Scott T. Dye, CPA

H.R. 436 was referred to the House Committee on Ways and Means Jan. 9. H.R. 436 ostensibly was written to repeal sections of the Economic Growth and Tax Relief Reconciliation Act of 2001, which repealed the estate tax for 2010 and reset the applicable exclusion amount to $1 million for subsequent years. The bill will reinstate the estate tax for 2010, set the exclusion amount at $3.5 million, freeze the maximum tax rate at 45 percent and continue with the current carryover basis rules which were set to change.

However, the bill goes one step further and eliminates minority discounts on all nonbusiness assets (also referred to as passive assets in the bill) held by an entity. These assets, if transferred, will be considered as if they had been directly transferred to the transferee and no valuation discounts will be allowed. The bill defines certain passive assets that are not to be considered as used in the active conduct of the business. Passive assets include cash or cash equivalents; stock in a corporation or any other equity, profits or capital interest in any entity; certain real property; commodities; collectibles; and other assets to be specified in regulations. Excluded from passive assets are amounts needed as operating capital.

It appears from the bill that operating entities could still be discounted, with one notable exception: transfers between family members. The bill specifically eliminates minority discounts for transfers of an entity to a transferee, if the transferee and members of the family, as defined in IRC Sec. 2032A(e)(2), of the transferee have control of such entity. This is in complete opposition to Rev. Rul. 93-12, which prevented attribution of ownership among family members. It was this ruling that has allowed family limited partnerships to flourish and families to transfer wealth at a discount. Presumably, a marketability discount will still be available for the FLPs that include operating businesses.

The outcome of this bill is uncertain, but, assuming passage, I believe we will see new FLPs effectively disappear as well as the need for valuations of these entities.

Scott T. Dye, CPA, ABV, CVA *is Business Valuation Section chair and a shareholder of Stoughton Davidson Accountancy Corporation in Fresno.*

Economic Damages

by Christian D. Tregillis, CPA

The Administrative Office of U.S. Courts is evaluating several proposed amendments to the Federal Rules of Practice and Procedure. Of particular relevance to experts offering testimony regarding economic damages, Federal Rule of Civil Procedure Rule 26, which defines required processes and disclosure of experts and expert testimony in federal litigation, has been proposed to be amended.

The most significant change is to expand application of the work-product protections of Rule 26(b)(3)(A) and (B) to experts. The effect of this proposal is to limit discovery of drafts of expert disclosure statements or reports and, with three exceptions, of communications between expert witnesses and counsel regardless of form (oral, written, electronic or otherwise). The exceptions are for those parts of the attorney-expert communications regarding compensation, identifying facts or data considered by the expert in forming the opinions and identifying assumptions relied on by the expert in forming the opinions.

Comments on the proposed amendments were due to the Secretary to the Standing Committee by Feb. 17, and a series of public hearings have been held on the proposed changes.

Under current rules, experts can in many circumstances be expected to produce drafts of reports, though there is ambiguity as to the definition of what constitutes a draft. For example, a draft may or may not be defined to include versions shown to counsel, different printed versions, electronic versions under different file names, versions overwritten on a computer (but with the same name), versions with the same name but on different electronic storage devices, and versions on different parts of a computer's hard disk or network, including e-mail servers. The issue is further complicated by the range of internal policies at firms on daft retention and the overwriting or purging of old files and e-mails, as well as the cost of maintaining different drafts or versions, and the inefficiency of experts not writing language in drafts for fear that it might be produced under an expansive definition.

A decision on the proposed changes, which would apply to only litigation in federal courts, is expected in the coming months.

Christian D. Tregillis, CPA, ABV, CLP *is Economic Damages Section chair and managing director of LECG in Los Angeles.*

Family Law

by Lionel T. Engleman, CPA

We are in the midst of dynamic and challenging times related to our family law practices. Challenges that family practitioners can expect in the near future include the following:

- The reduction of real estate values limits the borrowing capacity of the parties. This leaves less flexibility to provide for an equalizing payment and/or payment for professional fees.
- Protection of experienced staff from layoffs is important. The investment made in staff's knowledge base over the past years is hard to replace.
- Inexperienced firms may attempt family law engagements. The influx of untrained practitioners can produce quality control questions and taint the minds of the judiciary.
- There may be an increased demand for mediation, collaborative law and joint experts.
- It will be more important to require advance deposit fees and clarify stop-work provisions.
- Raising fees may not be an option. Conversely, reducing rates to buy into an engagement seldom works well in the immediate case and yields problems in the future.

On a technical note, several areas of our work need to be focused or refined:

1. The impact of subsequent events and/or

a down economy on a valuation of a business or professional practice.

2. The recurring or non-recurring nature of the income stream for child and spousal support, including the different bases used for each type of support.
3. The analysis of living expenses needs to consider several levels of expenditures—actual, estimated and/or proposed.
4. The impact of the current economic environment on Moore/Marsden and Walrath–Grinius apportionment calculations.
5. The use of "calculation of value" business valuations in family law matters. The divergence of opinions seems to be narrowing as to what part of our work can use this type of engagement.
6. Databases relating to business valuation—family law practitioners may consider reducing the costs through a pooled list of subscribers.

A recent case, *In re: Marriage of Berger*, CA-1, Division 3, G039234, involves the ability to distribute or not distribute S Corporation earnings and the related child support and spousal support needs. The ability to defer earnings and live on other assets (that may or may not have been community property) is the core issue in this case. A family law subcommittee has been following and summarizing various income for support cases and continues to watch for current developments in this area. A summary list is available at *www.calcpa.org/LIT*.

Lionel T. Engleman, CPA *is Family Law Section chair and shareholder in Engleman Accountancy Corporation in San Mateo.*

Message From the Chair

by Ronald L. Durkin, CPA

In my previous column I encouraged our litigation services practitioners to share their tools, talents and experiences with others in the profession. As we approach CalCPA's centennial, I wanted to recognize a dedicated group of CPAs who have served us as chairs of CalCPA's Litigation Support Committee (in 1984) and the various iterations of this title culminating in our current Litigation Sections format:

Thomas W. Rimerman (1984–85)
Michael G. Ueltzen (1985–87)
Michael J. Wagner (1987–89)
Donald L. Gursey (1989–91)
Henry Stotsenberg (1991–93)
Everett P. Harry III (1993–95)
C. Lucinda Bailey (1995–96)
Roger B. Shlonsky (1996–98)
John J. Costello (1998–00)
Ann E. Wilson (2000–02)
D. Paul Regan (2002–04)
Andrew M. Mintzer (2004–06)
Mark S. Luttrell (2006–08)

I also want to recognize Tom Rimerman and Mike Ueltzen, who went on to lead the profession as chairs of the AICPA Litigation Support Subcommittee.

Since 1986, CPAs from California have contributed greatly through their thought leadership by developing practice aids, discussion papers, books and articles on topics dealing with business valuation, damages, family law and fraud. California CPAs also have led by teaching courses on all of these topics. Today, California leads the nation by having more Certified in Financial Forensics designated professionals than any other state. We should all be proud of our leaders and I hope that you take the opportunity to thank them.

— **Ronald L. Durkin, CPA, CFF, CFE, CIRA** *is senior managing director of Durkin Forensic, Inc. in San Diego.*

Fraud

by Jennifer Ziegler, CPA

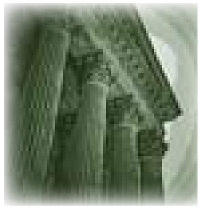
Extensible Business Reporting Language, or XBRL, is a method of formatting data and basically involves "tagging" each line item in a financial statement. These tags act like a bar code and make data easier to find and use. Effective June 15, approximately 500 public companies, or 85 percent of the public market, will be required to file their Form 10K, 10Qs and other filings in XBRL. The mandate becomes a reality or the remaining 12,000 filers over the next few years.

What does this mean to the U.S. financial world? XBRL has been hailed by some as a revolution of data, and described by Daniel Roth as "a radically transparent plan to remake the market." Some believe this could be the next gold rush, as the 12,000 small public companies' data will become easily accessible to the market and analysts. XBRL will become a useful tool for the auditor and internal investigator, as information will be available contemporaneously upon the filing of documents and reports can be designed and tailored to your specific needs.

For example, an audit committee hires you to investigate allegations that assets are being misappropriated. As the investigator, you can access data for public companies through an Excel add-in, available from *www.Edgar-Online.com*. An analysis of the financial information for companies in the same business, in the same geographic region with the same market capitalization is necessary. Additionally, all the standard industry ratios can be requested. The report takes a few minutes to run and results in an Excel document that shows the comparisons side by side. Next you take the developed report and click an icon to highlight all ratios 20 percent greater than the average. Voila—you have just created a report that will help you identify the accounts that you may want to review.

The days of manual input in creating financial spreadsheets for public companies will become the prehistoric. XBRL will give the investing public and financial markets information in a timely manner that in the past was difficult or impossible to find.

Jennifer Ziegler, CPA, CFF, CFE *is a director at Hemming Morse, Inc. in Los Angeles.*



Keepin' It **Legal**

Valuations During The Current Financial Crisis

by Darryl Snider, Esq.
and Leo Caseria, Esq.

My kingdom for a horse, sir. Any horse, just make it quickly. No, you say? How about a donkey? In today's rapidly changing economic climate, valuation experts must exercise extraordinarily sound judgment in their selection and treatment of key assumptions and inputs to arrive at reasonable estimates of fair value. The global financial crisis and economic recession have wrought dramatic, relentless and far-reaching consequences. Valuation experts, companies, auditors, investors, lawyers and judges have been thrust into a new world of instability, volatility and daunting challenges.

What is a building, business or security worth today—and what will it be worth tomorrow? If the expectation of falling prices, declining cash flows and distressed sales is factored into the model, then virtually nothing is worth what it was just a short time ago. By the same token, today's trend lines may reflect an emotional overreaction to present circumstances. Do we end up with values du jour as we feed ever-changing input assumptions into the models and run our sensitivities? There is more random noise than ever in the data and a heightened danger that results can be preordained by data and time period selection.

A recent Indiana federal court decision provides a good example of the need for increased rigor in updating key assumptions. In *Hoosier Energy Rural Electric Cooperative, Inc. v. John Hancock Life Insurance Company*, Case No. 1:08-cv-1560-DFH-DML, 2008 U.S. Dist. LEXIS 100353 (S.D. Ind. Dec. 11, 2008), plaintiff's expert looked at several "indications of value" of an electrical generating plant, including a 2002 appraisal, as well as book value of invested capital to market value of invested capital ratios for 11 publicly traded private electric utilities. (Id. at *18-19). The expert's indications of value posed "substantial problems." (Id. at *19). With respect to the 2002 appraisal, the court stated: "There is ample reason to think that the passage of time, including dramatic changes in financial markets over the past several months, has affected the value." (Id. at *20). With respect to the book value to market value ratios, the court faulted the expert for "bas[ing] his calculation on stock prices as of Nov. 26, 2008. Recent sharp fluctuations in stock prices show that this calculation is subject to fairly dramatic swings depending on the particular day used." (Id. at *20-21).

The court's observations in *Hoosier* highlight the importance of using conservative assumptions and inputs that accurately reflect current market conditions. Forensic accountants and economists should consider whether historical prices and costs provide meaningful guidance to current valuations or projected future values. Today, the ability to extrapolate from the data and follow trend lines is naturally curtailed. Increased volatility must also be accounted for when using a recent price index or price quote—a larger sample pool with more dates and more prices per date should be considered.

Although the plaintiff's expert in *Hoosier* attempted to value the asset using "indications of value," a more common valuation method is the discounted cash flow (DCF) analysis. Concerns regarding historical data and volatility are no less important when using a DCF analysis. A DCF analysis incorporates realistic projections from which future cash flows can be calculated and appropriately discounted. Valuations may often suggest a wide range of values, rather than a point estimate. There are many imponderables to address and ways to go astray.

Calculating the discount rate in a DCF analysis is typically done using the capital asset pricing model (CAPM), which is the sum of the risk-free rate of return and the risk premium, multiplied by the beta. What is the risk-free rate of return when the U.S. government can essentially borrow at a zero or negative interest rate? Risk premiums have increased, but by how much? The risk premium must cover both the investment risk of failing to obtain the expected rate of return and also the potential loss of capital. The beta is usually based on historical performance and is generally either a two-year beta or a five-year beta. Given the current recession, which some believe will last for some time and may result in a fundamental restructuring of the global and national economy, the use of two-year beta may be more appropriate to capture the risk associated with new marketplace realities. See, e.g., *Andaloro v. PFPC Worldwide, Inc.*, C.A. No. 20336, C.A. No. 20289, 2005 U.S. Del. Ch. LEXIS 125, *58 n.61 (Del. Ch. Aug. 19, 2005), which discusses pros and cons of two-year betas and five-year betas.

Valuations of assets held by businesses are also becoming difficult. The recent proliferation of exotic financial instruments including mortgage-backed securities and credit derivatives has significantly affected business values of financial and non-financial institutions. The complexities of these instruments and resulting valuation difficulties have contributed to the global financial crisis through paralysis and fear. Many of these instruments are valued using models. More than 80 percent of the assets reported at fair value by financial institutions are valued using models. (See Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting ("SEC Report"), at 205). Given the extensive leverage in financial markets, when the fundamental assumption of a continuously and actively traded market turned out to be wrong for many of the securitized instruments, there was a systemic failure of the global banking system of unprecedented proportions. In this economic environment, preparers of financial statements and valuation experts should carefully select appropriate inputs and assumptions for use in their models based on specific facts and circumstances, and consider extensive sensitivity testing.

Statement of Financial Accounting Standards No. 157 (SFAS-157), which was issued in 2006 and went into effect in 2008, was designed to provide guidance to preparers and readers of financial statements and standardize the way in which fair value is measured. Critics of SFAS-157 have argued that by subordinating the use of unobservable inputs and models to observable market prices in periods of reduced liquidity,

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AICPA Alert

by Christian D. Tregillis, CPA

Following Congressional testimony on mark-to-market accounting and its role in the troubles of the financial services industry, capital markets and the broader economy, the Financial Accounting Standards Board issued three Final Staff Positions (FSPs) April 9 to provide additional application guidance and enhance disclosures regarding fair value measurements and impairments of securities.

FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, provides guidelines on fair value measurements as called for by SFAS 157, *Fair Value Measurements*. FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*, calls for increased frequency of fair value disclosures. FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, provides guidance to clarify and to create consistency in accounting for and presenting impairment losses on securities.

"The issuance of these final FSPs follows a period of intensive and extensive efforts by the FASB to gather input on our proposed guidance," stated FASB Chair Robert Herz. "We received over 600 written comment letters, many e-mails and held many face-to-face meetings and other discussions with a range of affected constituents."

Among those offering statements on the proposals was the AICPA and its affiliate, the Center for Audit Quality. The AICPA's comments are available at *www.aicpa.org/mediacenter*. The March 12 Congressional testimony of CAQ Executive Director Cindy Fornelli is available at *www.thecaq.org/newsroom/release_03122009.htm*.

FSP FAS 157-4 relates to determining fair values when there is no active market or where the price inputs being used represent distressed sales. It reaffirms what Statement 157 states is the objective of fair value measurement—to reflect how much an asset would be sold for in an orderly transaction (as opposed to a distressed or forced transaction) at the date of the financial statements under current market conditions. Specifically, it reaffirms the need to use judgment to ascertain if a formerly active market has become inactive and in determining fair values when markets have become inactive.

FSP FAS 107-1 and APB 28-1 relates to fair value disclosures for any financial instruments that are not currently reflected on the balance sheet of companies at fair value, calling for quarterly disclosure. Prior to issuing this FSP, fair values for these assets and liabilities were only disclosed once a year.

FSP FAS 115-2 and FAS 124-2 is intended to bring greater consistency to the timing of impairment recognition, and provide greater clarity to investors about the credit and noncredit components of impaired debt securities that are not expected to be sold. The measure of impairment in comprehensive income remains fair value. The FSP also requires increased and more timely disclosures sought by investors regarding expected cash flows, credit losses and aging of securities with unrealized losses.

The FSPs are effective for interim and annual periods ending after June 15, but entities may early adopt the FSPs for the interim and annual periods ending after March 15.

More information is available at *www.fasb.org*.

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SFAS-157 has contributed to today's economic crisis. According to those critics, mark-to-market under SFAS-157 may require excessive write-downs during a period of sharply declining prices and shrinking liquidity, thus spurring further selling and price declines, creating a downward "liquidity spiral." (See SEC Report at 149, 182). Due to concerns such as these, the Emergency Economic Stabilization Act of 2008 (EESA) gave the SEC the power to revoke SFAS-157 and mandated that the SEC conduct a study of mark-to-market accounting and produce a report within 90 days. (EESA Sec. 132-133). The SEC reported its findings to Congress Dec. 30, 2008, and concluded "fair value accounting did not appear to play a meaningful role in bank failures occurring during 2008." (SEC Report at 4). Instead of suspending SFAS-157, the SEC recommended further guidance that would address the concerns surrounding SFAS-157 and fair value accounting.

Many of the SEC's recent recommendations aim to increase fair value guidance when markets are inactive or illiquid. (See, e.g., SEC Report at 8). The SEC Report also indicates that one of the coming changes may be additional disclosure requirements and increased transparency whenever fair value is measured using a statistical or economic model. (SEC Report at 184-85). The SEC issued letters to certain public companies in March 2008 (*www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm*) and September 2008 (*www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm*) that asked those companies to provide additional voluntary management's discussion and analysis disclosures (beyond SFAS-157's requirements) regarding the financial models used to measure fair value, as well the significant inputs and assumptions underlying those models. However, according to the SEC Report, "the call for additional voluntary disclosure of sensitivity analyses has generally not been answered." (SEC Report at 172). The SEC Report recommends further study of this issue, and notes that even with the risk of litigation, these additional disclosures may produce "net benefits to the capital markets." (Id. at 172, 185).

In the end, as stability returns and we gain greater experience with SFAS-157, including a better understanding of valuation techniques and models, particularly the sensitivity of results to changes in key assumptions, there should be a gradual restoration of confidence in valuations, financial statements and markets. And while there is now considerably more fodder for cross-examination of valuation experts by lawyers and judges, there will be a premium on transparency and the use of fundamentally sound valuation methods that conservatively reflect the new realities of the post-bubble global economy.

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Leo Caseria, Esq. *is an associate at the law firm Sheppard Mullin Richter & Hampton LLP in Los Angeles.*

HAPPENINGS

LITIGATION SECTIONS MEETINGS

Business Valuation	Thursday, Aug. 6, LAX Thursday, Nov. 5, OAK
Economic Damages	Tuesday, Sep. 15, LAX
Family Law	Friday, Aug. 7, LAX Friday, Nov. 6, OAK
Fraud	Wednesday, Sept. 16, LAX

Each section will send individual meeting notices.
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Fraud in Audit, Accounting and Tax Conference	Monday, June 25, BUR Friday, June 26 SF
Family Law Conference	Thursday, Oct. 22, LAX Friday, Oct. 23, SF

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reducing earnings volatility and the need to apply complex hedge accounting provisions. This statement is expected to expand the use of fair value measurement in financial statements. While it reduces volatility and allows for use of consistent measures, it is optional. This means that financial statements may use the existing book value of assets or may use fair values. Fair values may not have been used before and Statement 159 may lead to a change in measurement scale that must be considered when making historical comparisons. Moreover, all companies may not make the same choices in electing fair values, so comparisons across companies or with industry statistics will have to consider the implications of the measurement scale used.

For example, companies that have used the equity method to account for investments may switch to fair value reporting. The difference may be significant on both the income statement and balance sheet.

Statement 160 requires companies to report acquired assets and liabilities at fair value whenever a controlling interest is acquired. In the past, assets were only written up to fair value to the extent they were acquired in a business combination. For example, Company A acquires 80 percent ownership interest in Company B for $160. The book value of Company B is $100. Under prior GAAP, the total assets of Company B's assets on Company A's consolidated financial statements would be $180—the $160 paid by A for its 80 percent share of B and the original $20 book value of the 20 percent minority interest. That minority interest would be reported in the mezzanine section of the balance sheet. The assets representing the 80 percent interest purchased are written up to fair market value, but the assets representing the minority interest are not written up. Under the new standard, all of the assets are written up to the implied fair market value, so the total assets will be $200 and the minority interest (now called "noncontrolling interest") will be $40. The new standard categorizes the noncontrolling interest as part of stockholder's equity section of the balance sheet. In situations where less than 100 percent of the stock of a company is acquired in a business combination, this change will mean that assets will be larger because the acquired assets will be written up to 100 percent of their fair value. It also means that stockholders' equity will be larger because noncontrolling interest will now be part of stockholders' equity and the full fair value, instead of the book value, of the noncontrolling interest will be included in the consolidated financial statements.

Due Care

Due care must be exercised in comparing financial information during these times of financial reporting change. Financial reporting standards are changing to bring consistency worldwide and to improve the usefulness of the information to users. Use of more fair values will make some of our work easier. It is important, however, to be sure that you "read the label"—footnotes in our case—to know what information you are getting and that you are using that information appropriately.

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