THE Witness Chair

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

SUMMER/FALL 2011 California Society of Certified Public Accountants ISSUE 56

Company Specific Risk

by Ted Israel, CPA

At CalCPA Education Foundation's annual usiness Valuation Conference in San Francisco in June, James (Jim) Harrington of Duff & Phelps, LLC, and I presented results from our research over the past year on company-specific risk. What follows are highlights of our presentation. The complete text of my paper on Business Valuation Update is available at *www.calcpa.org/LIT/RiskyBusiness*. Jim expects to publish a paper on the topic later this year.

Our presentation focused on two points. I presented the issue of the potential for overestimating company-specific risk in valuing a small company when the analyst obtains a size premium from Morningstar/Ibbotson or Duff & Phelps. Jim focused on the blurring that occurs when considering the risk of the investment vs. the risk of the investor.

A quick review of cost of capital theory may be in order. Under the buildup model, the cost of equity capital is estimated:

$E(R_i) = R_f + RP_m + RP_s \pm RP_i \pm RP_u$,where:

- $E(R_i)$ = Expected rate of return of subject
- R_f = Risk free rate of return
- RP_m = Risk premium of the market (aka equity risk premium or ERP)
- RP_s = Size premium
- RP_i = Industry risk premium
- RP_u = Company-specific risk premium (aka unsystematic).

Under the modified capital asset pricing model (modified CAPM), the cost of equity capital is estimated as follows:

$E(R_i) = R_f + B(RP_m) + RPs \pm RP_u$

(All terms are the same as above, except B = Beta).

The notion that there is some overlap of the size premium and the premium for company-specific risk is not new. Shannon Pratt, in an introduction to an article in May 2005, stated, "I believe that, in most situations, much of what is listed among the specific company risk factor is captured in the size premium, so the specific company risk would rarely rise to 5 percent."

To understand this overlap, you must understand what conditions the company-specific risk premium is intended to address and the risk characteristics of the companies from which the size premiums are derived.

Under the buildup model and modified CAPM, the company-specific risk premium is supposed to address, at least in part, non-systematic risk, which is risk that can be avoided in a diversified portfolio. The owner of a private company is thought to be unable to diversify away his company's specific risk.

The buildup method and modified CAPM rely on return data of publicly traded companies. The company-specific risk premium is also intended to address perceived qualitative differences between these publicly traded companies and the private companies that are the subjects of many business valuations. It is assumed that the publicly traded firms have professional managers, sophisticated corporate governance, highly evolved systems and numerous competitive advantages, and that small private companies have little or none of these attributes. But this may not be a fair assumption, especially when considering the small publicly traded companies from which the size premiums are derived.

In Chapter 14 of *Cost of Capital: Applications and Examples*, Fourth Edition, Pratt and Roger Grabowski note, "Morningstar includes all companies with no exclusion of speculative (e.g. startup companies) or distressed companies whose market capitalization is small because they are speculative or distressed."

They elaborate with, "Decile 10y is populated by many large (measured by total assets) but highly leveraged companies with small market capitalizations that probably do not match the characteristics of financially healthy but small companies. There are companies with no sales included in the data (e.g. speculative startups). Stocks of the troubled companies included in the data (companies with negative returns on the latest fiscal year book value) …"

Unless they are all suffering from bad luck it would appear they may not benefit from all of the aforementioned advantages normally associated with publicly traded companies. This is an indication that the small public companies may be managed no better than the small private companies we are attempting to value.

Duff & Phelps is more selective of the companies it chooses to include in its statistics. For example, it excludes companies with sales less than $1 million in any of the previous five fiscal years or companies with negative five-year average EBITDA. Still, its data indicate that smaller is riskier.

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Inthisissue

Section Action

Business Valuation

by John Misuraca, CPA

NACVA recently devoted the last day of its annual Consultants Conference to conducting a mock trial involving a fictitious company against its patent attorneys. Attorneys, a jury of temporary workers hired from the local area and two participants from a NACVA expert witness class (one for the plaintiff, the other for the defense) participated.

The 200 conference attendees watched the proceedings on large video screens telecast live from separate rooms of the hotel. The premise of the trail was that the company, which was struggling financially, was suing its attorneys, to whom they owed millions of dollars in fees for past work, for failure to file for a patent by the deadline. Both expert witnesses presented their findings and dealt with the tough questions from opposing counsel.

The vast majority of the observers, all of whom are finance professionals, felt it was clear the company was doomed, even if it acquired the patent, and therefore should receive nothing. The jury members saw it much differently. To them, it was not clear that the company would fail even if it received the patent, and therefore they "should get something," even though they acknowledged much fault by the company.

When the deliberations ended, the jury wanted to award multiple millions to the company. Quite a contrast to the feelings of most of the observers!

The case clearly demonstrated that we, as experts, must remember we are not necessarily presenting to finance professionals. We instead need to find ways to simplify complex issues so those with minimal financial knowledge also can understand the facts of the case. The experts most successful in court may not be those who appear to possess the greatest financial knowledge, but instead may be those who can impart financial understanding to those who don't.

John Misuraca, CPA *is Business Valuation Section chair and managing partner with Avalon Advisors, Inc. in Laguna Hills.*

Economic Damages

by Craig M. Enos, CPA

Google Scholar is a free, easy and valuable tool to find and search articles, books, abstracts or court opinions on all types of topics, including economic damages. Google Scholar also allows you to create an email alert so you're notified when new opinions or articles have been added to the site.

What is Google Scholar? The Google Scholar "About" page defines it as: "Google Scholar provides a simple way to broadly search for scholarly literature. From one place, you can search across many disciplines and sources: articles, books, abstracts and court opinions, from academic publishers, professional societies, online repositories, universities and other websites. Google Scholar helps you find relevant work across the world of scholarly research."

From the Google Scholar homepage (*www.scholar.google.com*), enter your key words, such as "lost profits," and then select Articles or Legal opinions and journals. Once you have made your selection, click the search box. Once your search results appear, you can filter your search by legal opinions or articles, date and option to include citations.

If you would like to focus your search, you can select "Advanced Search," and search using exact words, exact phrase, publication, author or by several other options.

Once you have searched for legal opinions, you can easily narrow your search to California legal opinions and select a date range. The search result for lost profits, California courts in 2011 returned three pages of cases. From this result, you can click on the case caption to review the case, or if available, click on a link for related articles.

Google Scholar is a valuable tool that is best learned hands on. I encourage you to review the site and see how it can help you in your practice.

Craig M. Enos, CPA, ABV, CFF, CFE *is Economic Damages Section chair and owner of Enos Forensics in Folsom.*

Family Law

by Robert O. Watts, CPA

Before the California Senate is Senate Bill 481, introduced by Sen. Rod Wright. The proposed bill would require the court to consider the extent to which income for spousal support was already capitalized and paid in the division of community property in dissolution of marriage to avoid double counting the income when the result would be inequitable.

In more common terms, the bill would require the elimination of the "double dip," which may occur in both the division of assets and the future spousal support obligation of the payer spouse.

It was resolved at the bill's first hearing May 10 that further testimony would be allowed on the issue relating to those factors that are within the court's discretion in the determination of spousal support.

As written this proposal may or may not be too narrow in scope to resolve all potential questions on the asset/support double dip debate, but it does attempt to identify an issue.

SB 481 proposes changes to Sec. 4320 of the Family Code, relating to those factors used in determining spousal support. Existing law authorizes a court to issue an order for spousal support and sets forth some two dozen circumstances the court is required to consider in issuing the order. The court's use of Family Code Sec. 4320 factors gives it discretion in the reliance and consideration of those various circumstances in setting the level and duration of spousal support. An expansion and identification of further factors may not require the court to make a strict determination based on any one or several specific facts, but rather based on the circumstances presented.

The next scheduled hearing on the above issues is set for January 2012. Refer to your Family Law Section meetings for further discussions and developments on this topic.

Robert O. Watts, CPA *is Family Law Section Chair and partner with Gursey | Schneider LLP in Los Angeles.*

Fraud

by Barbara J. Gottlieb, CPA

The Supreme Court ruled (5-4) June 13, 2011, in the fraud securities case of *Janus Capital Group, Inc. vs. First Derivative Traders* that a mutual fund investment adviser cannot be held liable for securities fraud associated with falsities in mutual fund prospectuses.

In this case, Janus Capital Group (JC), created a group of mutual funds called the Janus Investment Fund (JIF). Janus Capital Management, LLC (JCM), a wholly owned subsidiary of JC, acted as investment adviser and administrator to JIF.

First Derivative Traders alleged under Rule 10b-5 of the 1934 SEC Act that the prospectuses issued by JIF contained false statements that subsequently led to a drop in JC's stock value, and that JC, as the "controlling person," was liable for the actions of JCM. Rule 10b-5, "Employment of Manipulative and Deceptive Devices," provides that it is unlawful for any person, directly or indirectly, to make any untrue statement of material fact in connection with the sale or purchase of securities.

The Court ruled that to pursue a 10b-5 action, the "maker" must represent false claims. However, "the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." Further, "one who prepares or publishes a statement on behalf of another is not its maker." As JCM served only as adviser and administrator, despite being "significantly involved" in the preparation of the prospectuses, it was not the "maker," and thus not liable.

The Court likened the relationship between JCM and JI to speechwriter and speaker: a speechwriter may draft the speech, but the speaker is ultimately responsible for the message. The Court acknowledged the significant influence of investment advisers over the mutual funds, but ultimately maintained that "corporate formalities were observed," and that JC and JCM "remain separate legal entities."

This ruling clearly narrows the scope of targetable entities for security fraud suits and encourages companies to "legally" separate themselves to be insulated from shareholder actions.

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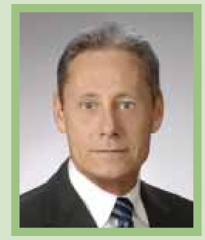
Message From the Chair

by Daniel W. Ray, CPA



Several months ago I wrote about technology's impact on the delivery of professional education. There are many that embrace webinars and podcasts to obtain necessary continuing education, as those methods are efficient and convenient. Others, however, advocate that the real benefit to attending meetings and conferences in person is the ability to meet with other professionals and the networking opportunities that follow. I described technology as a bit of a two-edged sword. This article will now touch on the topic of technology in the courtroom. To fully address this topic will take much greater space than I have here, and far more expertise than I possess. I do, however, want to explore the use of testimony by Skype and whether we are moving closer to virtual courtrooms.

This first instance came to my attention when a CalCPA Litigation Sections Steering Committee member told me that they were recently asked to testify at arbitration via Skype. The direct testimony was given from the expert's office, and the opposing counsel cross-examined the expert thereafter. After hearing about this expert's experience, I performed some internet researches to see how widespread or novel this practice was. I found in my limited research that testimony by Skype is in its infancy and often is being used, at least for the time being, only in extraordinary circumstances. Several articles described the use of Skype to obtain testimony from witnesses who were unavailable because they were out of the country or other extenuating circumstances. Other reasons cited for the use of this technology include cost savings, improved security for judges and a general assistance with the backlog of court cases.

Of course, like most everything else, there are those that criticize the use of this technology. There appears to be a debate as to whether testimony given over the internet satisfies the Sixth Amendment right of the criminal defendant to confront witnesses at trial. Some lawyers argue that although Skype is interactive (as opposed to taped testimony), it impedes their ability to effectively cross-examine witnesses because it hampers the "visual cues" and "subtle nuances" that are often employed.

A posting on the May 19 *Law Blog* offered the opinion that "… allowing a witness or a defendant to testify through webcam is not an impossibility, and the courts need to anticipate this happening. Courts will need to review the right to confrontation very thoroughly as this technology becomes more widespread."

Perhaps "virtual" courtrooms are in our future.

— **Daniel W. Ray, CPA, CFE, CFF** *is a director with Hemming Morse, Inc., CPAs, Litigation & Forensic Consultants in San Francisco.*

Litigation Sections Leadership Applications Being Accepted

We welcome your interest and encourage you to apply for a leadership position in the Litigation Sections, and to become involved in the future of the forensic and litigation consulting practice area. There are three member-at-large positions on the steering committee and the secretary office position. Additionally, each individual section will elect new officers, so it's your chance to get involved and make a difference. All Litigation Sections CPA members are eligible to apply and each position has a two-year term. You may apply for more than one position.

To download the application, visit *www.calcpa.org/lit/LitNominations*. The deadline is Nov. 11.

Keepin' It **Legal**

The Double Dip in Valuing Goodwill in Divorce

by Donald John Miod, CPA

The issue of double dipping has frustrated many business owners involved in a marital dissolution because of the potential financial hardship it may create. This article deals with identification of the problem, causes and some possible solutions.

The Problem

The two basic financial issues in a marital dissolution are property division and support.

When a business is included in the property division, it will most likely include tangible and intangible assets (goodwill). The calculation of income available for support will most likely include the same income stream that was used to compute goodwill. Hence, the double dip. This is because of the nature of goodwill: The expectation of what will be earned by the business in the future.

This may create a financial hardship or potential inequity for several reasons:

1. The business may be the only significant asset of the marital estate.
2. The business may have insufficient cash or other assets to distribute.
3. The goodwill may be a major portion of the value of the business versus equipment or cash in the bank.
4. The non-operating spouse may receive a note from the operating spouse in payment of his or her share of the business. The interest and principal payments will be made with after-tax dollars from the earnings of the business operator.
5. Spousal support and/or child support payments are to come from the earnings of the business operator.
6. The value of the business may have taken years to create. Trying to pay the non-operating spouse for their half may take a long time.

Intangible Assets

It may be best to begin the discussion of an intangible asset by stating that it is not something that you can touch, feel or freely liquidate.

The Business and Professions Code Sec. 14100 defines "goodwill" (intangible asset) as the " … expectation of continued public patronage." Goodwill, therefore, is an ability to earn in the future. Just because a business was profitable in the past does not automatically create value. It only has value if that past is expected to repeat itself, or will give some indication of future earnings.

Valuation of Goodwill

While many businesses have elements of goodwill, the question is whether that goodwill has any separate, distinguishable and quantifiable value.

To determine the value of goodwill at the valuation date, one must look to the future to estimate the "expectation of continued patronage." Webster defines "expect," in part, as "to look for as likely to occur." If it has not occurred, it must be in the future (measured from the valuation date).

Whether someone will pay for the goodwill based on past events depends entirely upon the expectations of the buyer. In real-life business acquisitions and valuations, when someone buys a business, they are dealing with what they expect to happen in the future. They may look to the past, but only if they think the past is some indication of what will happen in the future.

Family Law Goodwill

The appraiser's goal is to compute the community property interest in a particular business. Often, the business will be a service business whose success or failure depends on the efforts of the spouse operating the enterprise. We know from the law that efforts after the date of separation are no longer community property and become the separate property of the person performing them. A projection into the future of what the spouse could do is, in fact, a view of the separate property of the spouse operating the business. If our goal, once again, is to compute the community property value of the business, how can you use separate property to determine the community value?

The solution is to use historical (community) earnings and adjust them for what may not repeat itself (loss of a major product line, etc.). This is a surrogate for a projection. The difference is that you are using earnings during the marriage to determine the community value. It is then assumed that what the community has built (an ability to earn) will continue.

Principal or Income?

Part of the problem also stems from the distinction between Return *on* Investment and Return *of* Investment.

The above are problems because the courts, attorneys and litigants do not distinguish consciously between these concepts. The result: cash flow from a self-liquidating investment is mistaken for income. Stated differently, the goodwill (income which one spouse had paid for) is included by the courts as income available when it is a return of principal.

Accounting Issues and Considerations

There are no AICPA standards in the form of an Accounting Principles Board Opinion or by the Financial Accounting Standards Board that discuss or give direction to goodwill recognition in the area of family law.

The tax law also has no family law considerations, but it does have what is known as Sec. 197 intangibles. The tax law recognizes and allows the amortization of goodwill over a 15-year period. Exceptions to the 15-year amortization period are allowed where a useful life can be estimated with reasonable accuracy. A potential exception for unsalable goodwill may be the number of years until retirement.

Possible Solutions

Amortize the goodwill over an appropriate time period. Treat the dissolution transaction for what is really happening; one person is acquiring the other half of a business from another. When this happens in business, Sec. 197 intangible law generally applies. Perhaps it is time to allow a deduction for amortization of goodwill in family law situations involving spousal support.

There are issues to consider. For example, when dealing with a business

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AICPA Alert

by D. Paul Regan, CPA

It's not often that a crystal ball rolls around, but when one does, it can be wise to take a look inside. For those of us who wonder whether budgetary cuts, in combination with the ever-increasing costs of litigated actions, might one day culminate in changes to procedural rules, the future may be here.

The Colorado Pilot Project is an initiative of the Institute for the Advancement of the American Legal System (IAALS) and will be applied to business and medical malpractice actions in the District Courts of Colorado. The "business actions" umbrella applies to essentially all the types of cases in which CPAs serve as experts, including breach of contract, business torts, disputes involving commercial real property, owner/investor derivative actions, commercial class actions, commercial insurance coverage, dissolution of business entities, disputes involving antitrust laws and disputes involving intellectual property and state trademark laws. The Project goes into effect Jan. 1, 2012 for two years.

While the Project seeks to implement a number of proposals, such as eliminating even jointly stipulated scheduling extensions, experts will be most impacted by Project Proposed Rule 10.1(b). This section states that the "substance of each expert's direct testimony shall be fully addressed in the expert's report." PPR 10.1(b) takes on significant importance when read with PPR 10.1(d): "There shall be no depositions or other discovery of experts." Essentially, one report, no discovery, no deposition, we'll see you in trial and start with cross-examination of the expert.

In response, AICPA representatives met in May with IAALS executive director and retired Colorado Supreme Court Justice Rebecca Kourlis and her staff. Kourlis suggested that an AICPA task force would be welcomed to the process due to the knowledge and resources of our profession. Our very own Ron Durkin is chair of this AICPA task force, which will hold the first joint meeting with the IAALS in August. The results of the Project are being monitored by the National Center for State Courts and the American College of Trial Lawyers Task Force on Discovery. If successful, some or all aspects of the Project may soon appear in a venue near you.

D. Paul Regan, CPA, CFE, CFF *is chair of Hemming Morse, Inc., CPAs, Litigation & Forensic Consultants. He is a member of the AICPA's Forensic and Valuation Services Executive Committee.*

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For example, Exhibit C-7 to the 2011 Duff & Phelps, LLC *Risk Premium Report* gives some comparative risk characteristics for the 25 size portfolios based on sales. The companies in portfolio 25 (the smallest) have the lowest average operating margin (8.76 percent), the highest average coefficient of variation of operating margin (39.26 percent) and the highest average coefficient of variation of return on equity (49.99 percent). The latter two statistics indicate substantial income volatility.

This is in contrast to the smooth, stable earnings growth curve normally associated with publicly traded companies—further evidence that these companies are not managed any better than your subject private company. I can never resist quoting Peter Lynch, former head of Magellan Fund, "Go for a business any idiot can run, because sooner or later any idiot probably is going to be running it."

Valuation using the income approach involves a numerator (some measure of income), divided by a denominator (some estimate of the cost of capital). Our discussion has focused on the denominator. Valuation analysts frequently lose sight of how the perceived deficiencies of small private companies may affect the numerator of the foregoing capitalization equation. In other words, the absence of professional managers, sophisticated corporate governance, highly evolved systems, numerous competitive advantages, etc. already has a direct effect on the value of the company because its profitability suffers. It may be unnecessary to pump up the denominator of the capitalization equation for company-specific risk because the numerator (income) is already impacted by such factors. I believe much of a company's specific risk is "baked into" earnings figures.

In business valuation, he said, our focus should be on the risk of the investment. He presented calculations of historic security performance for companies held by diversified investors (mostly institutions) vs. non-diversified investors (held mostly by non-institutional investors) demonstrating, through Fama-French 3-Factor analysis, that while greater company-specific risk may be associated with the non-diversified holdings, the market did not necessarily compensate them with greater returns. This is significant. The inability to diversify away the risk of a specific investment (unsystematic risk) is a risk to the investor and has historically been considered synonymous with company-specific risk. Harrington's analysis indicates that unsystematic risk may be the wrong thing to focus on when estimating company-specific risk.

Harrington closed with a discussion of total beta and the Butler-Pinkerton total beta approach for estimating company-specific risk. He stated that he does not use total beta for estimating company-specific risk, in part because there are too many unanswered questions about the method. For example, he explained that he had examined total beta in the context of portfolio theory and the analysis suggests that total beta may only yield a correct result when all assets in the universe are perfectly correlated. Of course, such a world does not exist.

Like all elements and methods involved in estimating the cost of equity capital there will be continuing discussion of this issue until consensus is reached. Reliable, defendable valuations can only result from careful analysis by *informed* practitioners. To *stay* informed, read business valuation newsletters, attend conferences and attend CalCPA's Business Valuation Section meetings.

Ted Israel, CPA, ABV, CFF, CVA *is director of the Forensic and Valuation Services Division of Eckhoff Accountancy Corporation in San Rafael.*

HAPPENINGS

LITIGATION SECTIONS MEETINGS

All Sections Joint Meeting
Wednesday, Oct. 19; 5:30–7:30 p.m./reception
Thursday, Oct. 20; 9 a.m.–noon/Joint Meeting;
noon–4 p.m./breakout sessions
Marriott Hotel; Marina Del Rey

Business Valuation	Thursday, Feb. 9, OAK
Economic Damages	Wednesday, Jan. 11, OAK
Family Law	Friday, Feb. 10, OAK
Fraud	Tuesday, Jan. 10, LAX

You may register online or download a registration form at *www.calcpa.org/LIT.* For more information, call (818) 546-3506.

EDUCATION FOUNDATION CONFERENCES/COURSES

(800) 922-5272 or www.educationfoundation.org

Divorce and Small-Business Fraud	Monday, Oct. 24	OC North
Family Law Conference	Thursday, Nov. 3 Friday, Nov. 4	LAX SF
Fighting Fraud Using Data Analysis	Monday, Sept. 26	SJ
Financial Fraud Investigation Methodology	Tuesday, Oct. 18	SF
Valuation for Mergers and Acquisitions Transactions	Friday, Feb. 18	SJ

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operator who is close to retirement age, the amortization period may need to be shortened based on the specific facts and circumstances. Without some other well-reasoned method, the straight-line method could be employed with a 15-year period for the amortization. This would coincide with the current state of the tax law.

Other issues and opportunities for solutions. It is difficult, if not impossible, to design one solution to fit all situations. Other solutions can be created to fit the unique circumstances to each case. Care should be exercised to create a solution that is simple in design and can withstand mathematical modifications when circumstances change. If a business is salable, the same treatment could apply. The community goodwill (paid for by the spouse) will be amortized and then replaced with separate goodwill created by the future efforts of the operating spouse. The community goodwill that is being amortized can still be considered a principal payment and not income. When the business is sold in the future, some or even all of the goodwill can be viewed as created from the post separation efforts of the operating spouse.

There are situations where the analysis herein does not apply depending on whether the computation of the income available to the business owner is the entire income available to the business. For example, if the owner is not taking out all the profits of the business, for business reasons, then there may not be a full double dip. This is because there would be a difference in the income used for the valuation of goodwill and the income available for support.

For example, assume a business has a pre-tax profit of $500,000, and the owner only takes out $200,000, because the money is needed to fund the growth trend each year. If the court determines that the income available to the owner is only $200,000, there is not a complete double dip because goodwill was determined using the $500,000 in earnings.

The ability of the supporting party to pay is only one of the many factors the court considers in determining the level and duration of spousal support (Family Code Sec. 4320). It is hoped that in the future the courts will consider the economic reality of the double dip.

The law requires that child support be computed using all income of the parties. Because the children of the marriage are not a party to the property division, they do not receive assets or payment for goodwill of the business. Thus, child support would be based on income without regard to the amortization of goodwill.

Conclusion

Charging one party in a marital dissolution with the community property goodwill and using the same earnings to compute spousal support can be viewed as counting the same income twice. Many times this can contribute to the financial hardships that are inherent in the divorce arena. There are methods that can relieve these hardships and/or inequities.

Donald John Miod, CPA, ABV,CVA,CBA, FCPA,CFF, CFS *is a founding partner of Miod and Company, LLP in Mission Hills.*

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

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