

THE Witness Chair

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Morningstar Discontinues SBBI Valuation Yearbook: Summary & Solutions

by James P. Harrington

Morningstar announced in late September that it is discontinuing the *Ibbotson SBBI Valuation Yearbook* and other valuation publications and products.

These products have been widely used and cited in valuation reports for nearly 15 years, and were considered essential for every practitioner's toolbox.

It is important to understand that Morningstar stopped updating these products as of Sept. 30. End-of-year data (Dec. 31, 2013) will not be available for these products.

I came from Ibbotson Associates, and then Morningstar, where I was director of business valuation research in its Financial Communications Business. I was heavily involved with all of the Ibbotson SBBI publications and other valuation products from 2005–10, prior to joining Duff & Phelps. (Note: Morningstar purchased Ibbotson Associates in 2006.)

This article provides:

- A summary of Morningstar/Ibbotson valuation data not being discontinued.
- A summary of Morningstar/Ibbotson valuation data being discontinued.
- Alternative data sources.
- Solutions in the works.

Morningstar/Ibbotson Valuation Data Not Being Discontinued

Morningstar will continue to publish the *Ibbotson SBBI Classic Yearbook*. The *Classic Yearbook* is "the red book" and is "a history of the returns on the capital markets in the United States from 1926 to the present" (see *2013 SBBI Classic Yearbook*; Morningstar, Chicago, 2013; Page 1). The *Classic Yearbook*

has been published since 1983 and is based on a series of papers and articles written by Roger Ibbotson and Rex Sinquefeld.

According to Morningstar, the *Classic Yearbook* will continue to include "some" of the content previously available in the aqua-blue *Valuation Yearbook* (as it has for years), but it is important to understand that for many practitioners, the "some" will likely not be sufficient. Certain "key" variables for estimating the cost of capital found in the now-discontinued *Valuation Yearbook* will not be found in the *Classic Yearbook*.

Morningstar will reportedly continue to publish the following valuation data in the *SBBI Classic Yearbook*:

- Size premia for CRSP Deciles 1-10, Mid-Cap (a portfolio comprised of Deciles 3-5), Low-Cap (a portfolio comprised of Deciles 6-8), and Micro-Cap (a portfolio comprised of Deciles 9-10).
- The "historical" and "supply side" equity risk premium (ERP).

There are two pieces of data missing that are likely very important to most previous purchasers of the *Valuation Yearbook*:

- Morningstar will no longer split the 10th decile into subdeciles 10a (and its upper and lower halves, 10w and 10x) and 10b (and its upper and lower halves, 10y and 10z). The loss of these subdeciles will likely be important to practitioners who value smaller firms.
- Morningstar will no longer calculate industry risk premia (IRPs), previously found in Table 3-5 in the *Valuation Yearbook*. The IRP is used within the context of a build-up model. This loss is important to practitioners who use a build-up model in their valuation

analysis (alone, or in addition to the capital asset pricing model).

This book included the user-friendly "back page" that listed the risk-free rate, equity risk premium and the size premia that could be used for estimating the cost of equity capital using both the build-up model and the capital asset pricing model.

Morningstar/Ibbotson Valuation Data Being Discontinued

Table 1 summarizes the valuation data and products being discontinued by Morningstar. In recent years, this data had been provided in hardcover books and downloadable PDF reports, and on the Cost of Capital Resources website (*CCRC.Morningstar.com*).

However, according to Morningstar, the CCRC website was switched off as of Dec. 31.

The individual company betas were previously found in the discontinued *Ibbotson Beta Book*, but individual company betas (in downloadable PDF) were available on the CCRC website.

These individual company tearsheets helped practitioners form custom peer group beta information for use in valuation reports.

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Section Action

Business Valuation

by Denise M. Frey, CPA

The past two years as Business Valuation Section chair have been challenging and rewarding. The little voice that said, “They will not come,” was wrong. A number of national speakers were invited to California to give presentations to our group. Many said, “Yes”; for others, it was the timing that kept them from California. We also had fantastic presenters from the Bay Area.

We had a great day in February with Aswath Damodaran, who had no desire to stand at the front of the room for his presentation; he jumped over the table to the center of the room to be closer to his audience.

We spent a day on the “dark side of valuation”—and what a day it was.

In May we enjoyed our own version of Hardball with Hitchner. Jim Hitchner tossed tough questions to past Business Valuation Section chairs. They answered wisely, even if the audience and other panel members did not always agree with their opinions. Each question offered a lively discussion among the panel and the attendees.

Jim Harrington offered his views on the cost of capital in the morning session of the August meeting and came back in the afternoon to join the group in open topic discussions. We also heard from Jack Young, a local equipment appraiser, on the types and ways to value individual and bundles of equipment.

The October meeting welcomed Nancy Fannon with her views on tax affecting S corporations in business valuations and business valuation in the court. The presentation was well received, and this topic continues to be controversial.

We look forward to seeing you at our next meeting.

Denise M. Frey, CPA, ABV, CFF, CVA is Business Valuation Section chair and a manager at Eckhoff Accountancy Corporation in San Rafael.

Economic Damages

by Craig M. Enos, CPA

The calculation of future medical expenses has been a hot topic in recent depositions. What impact will the Affordable Care Act have on the calculation of future medical expenses?

The plaintiff in an individual damages lawsuit, i.e., personal injury, often has a claim for the value of future medical expenses. The comments I’m hearing from defense counsel are that the annual loss for future medical expenses should not exceed the annual cost of the health insurance premiums for an ACA-approved plan, plus the annual out-of-pocket maximum.

The argument is that one cannot be denied coverage due to pre-existing conditions and can buy insurance to cover the future recommended care.

This sounds reasonable in theory, but there are other issues to consider.

A life care plan, prepared by a doctor and priced by a Certified Life Care Planner, is often prepared when the plaintiff has suffered a personal injury resulting in the need for future medical care.

The purpose of the life care plan is to provide for the future medical care required as a result of the personal injury, that is, care above and beyond what was needed for the individual prior to the personal injury.

Our task as economic damages experts is to calculate the present value of the life care plan. Although I expect we, as the economic damages experts, will continue to be asked about the ACA, I believe the questions are more appropriately addressed to the life care planners.

For one to assume that the annual cost of future medical care recommended in a life care plan should not exceed the annual cost of health insurance premiums, plus the annual out-of-pocket maximum, you would need to assume:

- The injured party qualifies for an ACA-approved plan,
- The ACA approved plan will be available to the injured party for the remainder of the life care plan (often life expectancy)
- The insurance company will not be able to file a lien for reimbursement; and

- That all of the recommended medical care in the life care plan will be covered by the ACA plan.

I see interesting times ahead as the ACA is implemented and these questions get answered. I also see challenging times ahead for life care planners to distinguish between costs that are and are not covered by the minimum insurance requirements.

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

Family Law

by Dan Close, CPA

For forensic accountants practicing in family law, the general rule is that more documents are better, or the more document support you have, the more persuasive your opinions and conclusions. That is not the case in *Marriage of Ficke* (2013) 217 Cal. App.4th 10,157 Cal.Rptr.3d 870.

Facts: In this 15-year marriage, Husband owned separate property rental units; one had a mortgage and one was owned free and clear. Husband testified that the rental units were self-supporting—the income received from rent was more than adequate to cover the mortgage and other costs.

Also, it was noted that the community paid off the remaining mortgage balance on the encumbered rental property during the marriage.

This scenario appears to involve a tracing of funds by the forensic accountant to determine if, in fact, the rental properties were self-supporting and that no community funds were co-mingled with the separate funds. Appropriate documents would be requested and analyzed, showing community and separate property interests and/or any reimbursement issues.

However, in this case, the Husband did not produce those documents and instead testified that the rental property account was a separate account, i.e., not co-mingled.

The trial court accepted Husband’s testimony without document proof. Although the court ruled that there was a community interest in the rental property of \$231,500 because community funds (obviously originating from a source other than the rental property bank account) were used to pay off the remaining mortgage balance, it otherwise held that the rental properties were Husband’s separate property.

Wife argued on appeal that Husband did not produce the specific bank account records; therefore, the court should conclude that the mortgage payments came from community property.

The Appellate Court disagreed and cited *See vs. See*, (1966) 64 Cal.2d 778: “The need for specific records is the product of two factors: (1) the combination of commingling of separate and community funds and (2) the general presumption that property acquired during marriage is community.”

The Appellate Court went on to explain in *Ficke* that “the need for specific records and documents to trace funds is thus predicated on the existence of a commingled account.”

The troubling point here, in my opinion, is that the court accepted Husband’s testimony that no community property funds were deposited into, i.e., co-mingled with, the separate property bank account, even though Husband did not produce records to prove his point.

The *Ficke* case makes for interesting reading because there are a number of issues that are of interest to family law forensic accountants.

M. Daniel Close, CPA, ABV, CFF, CVA is Family Law Section chair and a shareholder of EDR Valuations, Inc. in Solana Beach.

Fraud

by Peter W. Brown, CPA

Effective board oversight remains a topic of great interest in today’s changing business and governance environment.

New rules brought in by the Dodd-Frank Act, coupled with increased shareholder activism, are creating an environment marked by increased compliance demands and regulatory requirements.

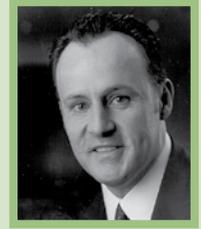
In this changing landscape, board composition matters more than ever. A combination of individuals with the right blend of expertise and experience is critical to board effectiveness. Diversity is also important across industry, geography, work experience, race and gender.

Not surprising, industry and financial expertise are the most highly ranked attributes sought among potential directors, according to a recent PwC survey.

International, operational and technology/digital media expertise also ranked as attractive draws, while human

Message From the Chair

by Peter Salomon, CPA



For CPAs who provide litigation and dispute resolution services, participation in CalCPA’s Forensic Services Section is a great way to network with fellow practitioners from across California from a wide variety of firms.

In addition, FSS members receive excellent training at our semi-annual meetings: One in Southern California and one in Northern California.

At these meetings members from the individual sections—Business Valuation, Economic Damages, Family Law and Fraud—meet together for the morning session and lunch, and then in the afternoon, each of the individual sections have separate meetings related to that specialty area.

At our most recent meeting in Oakland, we had approximately one-third of the FSS membership attend the all-sections joint meeting. One of the purposes of these meetings is to increase awareness of new and important developments impacting forensic CPAs, regardless of their area of specialization.

In addition, individual sections have separate all-day meetings two to three times per year. Attendance and participation at these meetings is another great benefit to being an FSS member. As an FSS member, you are eligible to attend meetings of any of the four individual sections, which are held on different days to avoid competition between Sections for attendance.

There are also periodic FSS related meetings held by CalCPA chapter committees for various geographic regions in California, e.g., San Diego, Inland Empire, Channel Counties, Bakersfield, Fresno, etc. These meetings are designed to provide education and networking opportunities for forensic CPAs who don’t live near Los Angeles or San Francisco.

If you are interested in learning more about FSS, visit the CalCPA website at www.calcpa.org/fss.

— **Peter A. Salomon, CPA, CFF** is a principal with Hemming Morse LLP in Los Angeles.

resources and legal expertise were considered less important, according to the survey.

Boards turn to fellow directors as the first source in board member searches. In fact, about 91 percent of the survey respondents in PwC’s study said they rely on recommendations of fellow board members when they look for a new director. Search firms and management recommendations ranked second and third, respectively.

When recruiting new board members, 11 percent of directors said they look to investor recommendations.

Mitigating fraud risk remains a significant issue for directors. The SEC filed 734 enforcement actions in 2012, just one shy of the previous year.

There were also more than \$3 billion in penalties and disgorgement.

The SEC received more than 3,000 tips

from its whistleblower program in 2012, the program’s first full year, and it has paid its first reward.

Most companies have responded to the new rules by placing greater emphasis on employee awareness of company ethics and compliance requirements and enhancing the company’s follow-up process on compliance-related complaints.

It is management’s responsibility to ensure compliance with federal securities laws, but it is the board’s job to provide the oversight to ensure that whistleblower policies are working.

In this new era of heightened board responsibilities, having board members who understand the risks of fraud and how to properly manage those risks is of paramount importance.

Peter W. Brown, CPA is Fraud Section chair and a director with PricewaterhouseCoopers LLP in Los Angeles.



Keepin' It
Legal

providing guidance as to the proper recording of transactions.

- Offering directions regarding how to properly record journal entries.
- Involvement with the implementation of accounting standards and guidance.
- Creating, compiling or editing information, discussions or data incorporated within financial statements and the related notes and disclosures.

witness, Jonathan Macey, defined “practicing accounting” as “calculating or computing specific numbers for inclusion in public filings; making substantive accounting determinations in connection with the preparation of public filings; or making determinations regarding the accuracy or appropriateness of public filings.”

Practicing as an Accountant Before the SEC

by David Callaghan, CPA

A 2013 decision from the United States District Court for the District of Columbia in *Securities Exchange Commission v. Gary A. Prince* provides clarification regarding activities that can be viewed as practicing as an accountant before the SEC.

Well before the SEC brought this case, the defendant had been permanently barred from practicing as an accountant before the SEC due to his actions while employed at a public company.

The SEC pursued this case to protect the integrity of the public financial reporting process by preventing an individual, the defendant, who was subject to a permanent bar, from ignoring the restriction by practicing as an accountant before the SEC. The SEC also sought to determine whether or not the defendant’s actions subsequent to the issuance of the permanent bar constituted practicing as an accountant before the SEC.

The judge’s decision identified various activities undertaken by the defendant that are appropriately viewed as practicing as an accountant. These include, but are not limited to:

- Making non-quantitative decisions about how to apply accounting principles and evaluate financial and non-financial information.
- Deciding quantitative issues, such as determining how numbers and data should be treated within an entity’s financial statements.
- Determining the amounts of accruals and

Background and Framework for Decision

SEC Rule 102 (e) allows the SEC to “deny, temporarily or permanently, the privilege of appearing or practicing before [the Commission] in any way to any person who is found by the Commission ... to have engaged in unethical or improper professional conduct.”

This rule is directed at protecting the integrity of the Commission’s own processes, as well as the confidence of the investing public in the integrity of the financial reporting process.

In 1997, the SEC issued a Rule 102(e) Order against the defendant, which permanently prohibited the defendant from exercising “the privilege of appearing or practicing before the Commission as an accountant.”

SEC Rule 102 (f) defines “practicing before the Commission” to include “[t]he preparation of any statement, opinion or other paper by any ... accountant” if that document is filed with the SEC. The dispute in this case centered on whether or not the activities completed by the defendant constituted the preparation of materials filed with the SEC by an accountant.

A leading decision addressing the issue of practicing before the SEC is *Robert W. Armstrong III*, SEC Release No. 34-51920. The decision “recognizes that financial statements often incorporate information created, compiled or edited by accountants who are not responsible for signing or filing the financial statements. Thus, practicing before the Commission includes computing the figures and supplying the data incorporated into Commission filings and consenting to their incorporation.”

Opinions and Positions Offered by Defendant’s Expert

Prior to the trial, the defendant’s expert



The SEC pursued this case to protect the integrity of the public financial reporting process by preventing an individual, the defendant, who was subject to a permanent bar, from ignoring the restriction by practicing as an accountant before the SEC



Macey’s trial testimony showed that his definition of “practicing accounting” was more limited. During cross-examination it became clear that Macey’s definition was limited to two groups of individuals: low-level accounting personnel tasked with entering transactions and the individuals with the ultimate and final authority over the numbers that are included in a company’s public filings.

Macey’s definition of practicing accounting excluded reviewing and deciding on accounting treatments, even if those actions affect the data included in a financial statement, unless those people have final authority to implement their suggestions.

The judge ruled that Macey’s narrow definition was not consistent with the guidance provided by the *Armstrong* decision, which rejected the premise that only those “responsible for signing or filing the financial statements” were practicing accounting.

The judge’s ruling also determined that Macey’s definition did not capture the fact that accounting is not simply a mechanical, quantitative endeavor. Instead, preparing financial statements and the practice of accounting can require making important non-quantitative decisions with subjective characteristics and considerations.

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AICPA Alert

by Greg J. Regan, CPA

Much has been afoot at the AICPA. The Forensic & Valuation Services Conference was held in November. During the conference, the AICPA feted both the fifth anniversary of its Certified in Financial Forensics credential and the 15th anniversary of the Accredited in Business Valuation credential.

Notable sessions included “Challenges in Projecting Future Lost Profits” by CalCPA members Brian Brinig and Jeff Kinrich. A keynote address by Scott Clemons of Brown Brothers Harriman asked and answered: If you had to make one investment today that you could not liquidate or sell for 100 years, where would you make it?

After dissecting global opportunities, Clemons concluded the United States provides the best balance of risk and return for investors.

Beyond the conference, the AICPA has kept the pedal to the metal with recent releases of two practice aids. The first involved *A CPA’s Guide to Family Law Services*. The updated version seizes upon the knowledge accumulated by practitioners since the original version was released in 2005.

A special mention goes to CalCPA’s Tracy Katz, who was one of the principal contributors to the update.

The second major update was to *Measuring Damages Involving Individuals*. It provides guidance for practitioners performing damages analysis in disputes associated with personal injury, wrongful death and employment discrimination. The original version was released in 1998. Input by CalCPA members Craig Enos and Susan Bleecker contributed to the update.

These practice aids, and others, are available (free to members) on the AICPA’s website. Practitioners should expect additional updates to the AICPA’s portfolio of existing practice aids in the coming months.

Finally, congratulations to Annette Stalker, who was named 2013 AICPA Forensic Volunteer of Year.

Greg J. Regan, CPA, CFF is a partner at Hemming Morse LLP in San Francisco.

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The *Ibbotson Cost of Capital Yearbook* was the “big green book” that included industry-level statistics and valuation data for approximately 350 individual industries, organized by SIC code. These tearsheets included industry valuation multiples and betas, cost of equity capital (COE) and weighted average cost of capital (WACC), calculated using various cost of capital estimation methodologies.

The industry tearsheets were excellent resources for industry-level cost of capital information for use in valuation reports.

These reports also helped support (and check) the practitioner’s own custom analysis of the subject company’s industry.

Morningstar/Ibbotson’s international cost of capital reports consisted of:

- *International Cost of Capital Report* (cost of equity estimates for 170-plus countries from the perspective of U.S.-based investors with investments in other countries around the world);
- *International Cost of Capital Perspectives Report* (cost of equity for 170-plus countries from the perspectives of investors based in Australia, Canada, France, Germany, Japan and the United Kingdom); and
- *International Equity Risk Premia Report* (historical equity risk premia for 16 countries, including the United States).

Alternative Data Sources

Duff & Phelps announced it will provide the data previously published in the *SBBI Valuation Yearbook* in its new publication, the *Valuation Handbook—Guide to Cost of Capital*. Duff & Phelps managing director Roger Grabowski says that the new 2014 *Valuation Handbook* will include all of the critical year-end data that was previously available in the *SBBI Valuation Yearbook* and that “the new *Valuation Handbook* will be timed to provide users of SBBI valuation data with a source of data to complete year-end valuations without interruption.”

Duff & Phelps Risk Premium Report, like the former *SBBI Yearbook*, provides data and methodology to assist financial professionals in estimating the COE for a subject company using CAPM and various build-up models.

While the *Risk Premium Report* will not be a stand-alone publication, all of its data will be included in the new *Valuation Handbook*.

The 2014 version of the Duff & Phelps web-based *Risk Premium Calculator* will also include all of the data available in both the former *SBBI Valuation Yearbook* and the *Risk Premium Report*.

Publisher’s Note: *At print time, we were unaware why Morningstar discontinued the products mentioned, or of any other substitute resources, besides those from Duff & Phelps.*

James P. Harrington, MBA is a vice president and director in the Chicago office of Duff & Phelps and is part of the Office of Professional Practice.

Table 1:

Books/PDFs Discontinued	CCRC.Morningstar.com Discontinued
Ibbotson SBBI Valuation Yearbook	SBBI Valuation Essential module *
Individual Company Betas (PDF)	Company Betas module (also sold as PDF tearsheets)
Ibbotson Cost of Capital Yearbook	Industry Analysis module ** (also sold as PDF tearsheets)
International Cost of Capital Reports (PDF)	International Cost of Capital module (also sold as PDF tearsheets) <ul style="list-style-type: none"> • International Cost of Capital Report • International Cost of Capital Perspective Report • International Equity Risk Premium Report

* Included the most essential information from each of the 1999-2013 *SBBI Valuation Yearbooks*.

** PDFs of individual industry analysis pages from the *Ibbotson Cost of Capital Yearbook* over time.

HAPPENINGS

FORENSIC SERVICES SECTION 2014 MEETING DATES

Business Valuation	Thursday, Feb. 20	LAX
Economic Damages	Tuesday, Feb. 11	SAC
Family Law	Friday, Feb. 21	LAX
Fraud	Wednesday, Feb. 19	LAX
All Sections Meeting	Wednesday, May 28	LAX

An individual meeting notice will be sent and you may register online at www.calcpa.org. For more information, call (818) 546-3502.

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Opinions and Positions Offered by SEC's Expert

The SEC's expert witness, Lynn Turner, described how the preparation of financial statements and the related disclosures involve quantitative and non-quantitative decisions about how various accounting principles and treatments should be applied to underlying data.

Because non-quantitative decisions may greatly affect the final numbers that are included in the financial statements, those who participate in making those decisions are "creating" and "compiling" the relevant information and practicing accounting, even if they do not have final authority over the final numbers that are presented.

Also, the implementation of Generally Accepted Accounting Principles and the rules of the Financial Accounting Standards Board require complex decisions involving the exercise of accounting judgment.

Part of functioning as an accountant, and "creating, compiling or editing" the information or data incorporated in a financial statement, is making such decisions.

The following examples illustrate the defendant's active involvement in the process of financial statement preparation and his practicing as an accountant.

Actions of the Defendant

A variety of evidence highlighted the

activities undertaken by the defendant that indicated he was acting as an accountant. The evidence showed that the defendant made decisions regarding the accrual of bonuses given to employees at a subsidiary, as well as directed parent company personnel to make sure that the numbers he had determined were properly reflected in the consolidated financial statements that were filed with the SEC.

The defendant wrote to the controller of a company subsidiary and offered his opinions on how to correctly book certain journal entries when closing its financial statements. He made specific recommendations as to how certain items should be recorded. He identified an entry and suggested the transaction be booked to additional paid-in capital instead of retained earnings. He also noted another transaction and recommended that the item be recorded within a particular expense item.

The defendant was actively involved with the company's implementation of Financial Accounting Standard 123 during a reporting period. He wrote and sent a lengthy email to the company's senior management and accounting staff explaining what he called "my plan" for implementing the updated accounting guidance and addressed potential adverse impacts to the company's income and financial statements.

Other examples demonstrated accounting-related recommendations made by the defendant during the absence of the company's CFO. He suggested creating and noting a particular reserve in the company's financial statements. He also worked with others in the accounting department to determine how a particular contract dispute should be recorded.

These were examples of substantive financial judgments that affected the company's financial statements and the information provided to the investing public.

Resolution

The narrow definition of practicing accounting offered by the defendant's expert witness was not accepted. The judge did not agree with the position that only low-level accounting personnel and the individuals with the final authority for the numbers in the financial statements are practicing accounting.

Instead, the judge determined that the defendant had practiced accounting before the SEC in violation of his accounting bar. The judge also reaffirmed the previous Order permanently barring the defendant from practicing before the SEC as an accountant.

David Callaghan, CPA is a director at *LitiNomics in Los Angeles*.

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