AICPA Alert

by Ann E. Wilson, CPA

The AICPA's Litigation and Dispute Resolution Services Subcommittee (LDRS) met in St. Louis July 30–31, including a half-day joint meeting with the Business Valuation Subcommittee.

Meeting highlights included:

- The LDRS voted to change its name to Forensic and Litigation Services Subcommittee (FLSS).
- Jim Feldman of the AICPA reported that he is drafting the portion of the AICPA's *Audit Committee Toolkit* that deals with the role of forensic accountants.
- Ron Durkin presented a draft paper titled *Incorporating Forensic Procedures in an Audit Environment*. The paper discusses SAS 99 implementation. The AICPA is deciding in which publication to print the paper. Durkin also reported that he is serving as chair of the AICPA's Antifraud Programs and Controls Task Force. The task force is a joint effort between the FLSS and the Audit Standards Committee. The task force will focus on fraud deterrence procedures and internal control.
- Shari Lichtman of the AICPA reported on efforts to organize the Forensic and Litigation Services portion of the AICPA Antifraud & Corporate Responsibility Resource Center (Resource Center). FLSS members are suggesting content for the website. The Fraud Task Force, headed by Bert Lacativo, is also assisting the AICPA staff with structure and content for the Resource Center.
- Les Hand, a partner at KPMG in San Francisco, will chair the Standards Task Force, which will evaluate whether or not Consulting Services Special Report 03-1, *Litigation Services and Applicable Professional Standards,* should be issued as a professional standard.

The FLSS welcomed six new members to the committee. From Los Angeles are Jeff Kinrich of the Analysis Group and Troy Dahlberg of Ernst & Young. The other new members are: Tom Burrage, Albuquerque, N.M.; Yvonne Craver, Washington, DC; Richard Pollack, Miami, Fla.; and David Kast, Colorado Springs, Colo. Michael Ueltzen and Sharyn Maggio are rotating off the FLSS.

As reported in this column in the last issue, the FLSS had a booth at the American Bar Association meeting in San Francisco in early August. The consensus is that this was a worthwhile endeavor and the beginning of a larger effort to promote the value of CPA experts to the legal community. The AICPA produced a brochure titled *CPA: Adding Value to Your Case at Every Step*, just for this meeting. CalCPA also provided various Litigation Sections handouts. Many thanks to the CalCPA members who staffed the booth at the four-day conference: Jim Andersen and J. Michael Drewes of Andersen & Co.; Leslie Dawson and Don Glenn of Glenn & Dawson, LLP; Kevin K. Chiu, M. Monica Ip, Michael McPartlan, Jennifer A. Prager, and Monica N. Rutt of Hemming Morse, Inc.; and Paul Scott, CPA. Their participation was greatly appreciated.

Ann E. Wilson, CPA, CFE is a member of the AICPA's FLSS. She is a sole practitioner, with offices in Solana Beach and Pasadena.

Keepin' It Legal

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which seeks to determine whether or not the debtor can pay its debts as they mature, this test seeks to determine if the post-transfer capital can withstand economic downturns or other unforeseen business changes. The CPA considers any significant available financial resources on the debtor's balance sheet as of the transfer date and the debtor's ability to obtain additional financing.

In testing for adequate capital and cash flow, the CPA should include a range of assumptions about expected future operating performance. The projected scenarios should include the expected results, as well as a pessimistic forecast that would involve lower estimates for variables such as revenue growth, profit margin, and working capital needs. By performing these "stress tests," the CPA can opine on the debtor's solvency or insolvency if the most likely set of projections are not met.

With the increase in business bankruptcies over the past several years, trustees and other interested parties have demanded many more solvency opinions in an attempt to limit liability. The CPA is well suited to perform this analysis. A business valuation credential, such as Accredited in Business Valuation (ABV) offered by the AICPA or Accredited Senior Appraiser (ASA) offered by the American Society of Appraisers, is also helpful in securing work on solvency engagements. CPAs interested in performing solvency analyses should attend training courses in business valuation and solvency, as well as review relevant court judgments in solvency related matters.

Mark Hayden, CPA, ABV, CFA, ASA is a partner in the Global Investigations and Dispute Advisory practice of Ernst & Young LLP in Los Angeles and specializes in bankruptcy disputes.

Ivan Lehon, CPA, CFA is a senior manager in the Global Investigations and Dispute Advisory practice of Ernst & Young LLP in New York.

Richard Lee, CPA is a manager in the Global Investigations and Dispute Advisory practice of Ernst & Young LLP in Los Angeles.

H A P P E N I N G S

Litigation Sections Meetings

Business Valuation	Thursday, Feb. 5, 2004, LAX Thursday, May 13, 2004, North Thursday, July 22, 2004, LAX Thursday, Sept. 16, 2004, North
Economic Damages	Future meetings TBA
Family Law	Friday, Feb. 6, 2004, LAX Friday, May 14, 2004, North Friday, July 23, 2004, LAX Friday, Sept. 17, 2004, North
Fraud	Tuesday, Feb. 24, 2004, TBA

Each section will send individual meeting notices.

Education Foundation Course Offerings—(800) 877-5897

Business Valuation & Succession Planning: A Practical Approach	Tues., Nov. 4, LV Thurs., Dec. 11, SF
California Community Property	Mon., Nov. 17, LAX
Family Law Conference	Fri., Nov. 14, LAX Fri., Nov. 21, SF

What's Better

Continued from Page 1

operates and a loss of business value could be determined once the business ceases operations.

The ability to use hindsight also distinguishes the approaches. When performing a business valuation, information is limited to that which is "known or knowable" as of the valuation date; one must generally ignore facts and circumstances occurring after the valuation date. Conversely, when performing lost profits analyses, courts may be willing to consider facts that have occurred through the date of trial.

Another key difference between lost profits and loss in business value involves the cash flows or earnings streams used in the calculations. Lost profits analyses typically are performed using pre-tax earnings streams because the award itself is generally taxed, while business valuations are typically performed using after-tax amounts to the enterprise.

No discussion about the differences between lost profits and loss in business value would be complete without discussing discount rates. As of this writing, there are only a few published cases related to approaches for determining discount rates when calculating lost profits. Not surprisingly, there are differing views within the profession on the subject. Some practitioners believe that the discount rate should incorporate all of the risks associated with the projected cash flows, similar to what is done in business valuations. Others argue that the discount rate should reflect a reasonable investment of the award.

As with lost profits analyses, practitioners often disagree on the appropriate discount rate when determining the value of a business. However, the approaches for determining discount rates for business valuations are well documented. It is the application of the approaches that varies widely. What is undisputed is that discount rates tend to have significant impacts on damages, and disagreements regarding the appropriate rates are very common.

The facts and circumstances of each case should determine whether economic damages are best measured through lost profits or the loss in business value.

Troy Dahlberg, JD, CPA, ABV is chair of the Economic Damages Section and leads Ernst & Young's Global Investigations & Dispute Advisory practice in the Pacific Southwest.

Peter Brown, CPA, ABV is a senior manager in Ernst & Young's Global Investigations & Dispute Advisory practice in Los Angeles.

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Editor
Susan Bleecker

Associate Editors
Leslie Dawson
Maria Nazario

Sections Chair
D. Paul Regan

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CalCPA Staff Liaison
Maria Nazario

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The Witness Chair

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

FALL 2003 ISSUE 32

Which Analysis is Better—Lost Profits or Loss in Business Value?

by Troy Dahlberg, CPA
and Peter Brown, CPA

So what's better? Well, it depends. In terms of economic damages, experts typically measure damages by calculating either lost profits or loss in business value. Depending on the facts of the case, either approach may apply. This article will compare and contrast the two methods and provide insights on which approach would be appropriate under the circumstances.

A lost profits calculation usually involves determining the profits that the plaintiff would have made "but for" the actions of the defendant. The actual results are then subtracted from the plaintiff's "but for" performance during the damage period. The difference between the "but for" and actual ordinarily determines the plaintiff's lost profits.

A loss in business value calculation involves two separate valuations. The first values the business just prior to the damage; the second values the business after the harm has occurred. The difference between the two appraisals is what determines the loss in business value.

The evolution of each approach has varied. Business valuation methods are well-published and widely accepted. Conversely, the rules governing lost profits are much less stringent and can vary by jurisdiction. Why? The answer lies in the geneses of the two approaches.

Business valuation standards are well documented. Most appraisers adhere to relevant professional standards when performing business valuations. In addition, various professional organizations have done outstanding jobs documenting accepted valuation practices. Internal Revenue Service rulings and Tax Court cases have also provided guidance. IRS Revenue Ruling 59-60 provides guidance for determining the approach, methods, and factors to be considered when valuing the shares of a closely held corporation.

Methods for determining lost profits have evolved primarily through commercial litigation and have been documented in publications such as the *Litigation Services Handbook,* Third Edition (John Wiley & Sons, Inc.). In addition, practitioners should refer to published court cases dealing with the technical aspects of lost profits damages calculations. However, practitioners must be mindful that each case is unique, and the exercise of making the plaintiff whole naturally depends on the facts and circumstances of an individual case.

Considering the primary differences between lost profits and loss in business value calculations, of particular importance is the recovery period. In many cases, lost profits cover a specific and finite time period and damages are incurred until the plaintiff has recovered from the harm caused by the defendant. Lost profits are generally calculated until the plaintiff has recovered to the level the enterprise would have been if not for the harmful act. This may differ from valuation theory, which is often built on the assumption that businesses operate into perpetuity.

Determining which method to use depends on the facts and circumstances of the case. Most practitioners would argue that in the case of a temporary impairment, lost profits is the most appropriate measure of damages. When a business has been totally destroyed, loss of business value is likely to be the most appropriate method for calculating damages. However, when you have deterioration in business that eventually leads to ceasing operations, some practitioners argue that a combination of methodologies is appropriate. Lost profits could be used during the period in which the business still

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In this Issue

Section ACTION

Business Valuation

by David F. Helms, CPA
and John W. Toney

Regardless of the method used to develop the discount rate for an income approach in a business valuation, the discount rate typically includes: 1) a risk-free rate, 2) an equity risk premium, 3) a size element, and 4) a specific risk adjustment for the subject investment. Historically, no commonly accepted empirical support has been available to directly determine the final component. However, in the last few years, Ibbotson Associates' (Ibbotson) industry risk premia data have become useful appraisal tools.

The data, first published in Ibbotson's *SBBI 2000 Yearbook*, rely on a beta estimation process that evaluates a specific industry's risk characteristics to come up with a risk premium for that industry. Ibbotson's latest publication, the *2003 Yearbook*, contains information on more than 300 industries.

A recent case highlights the use of the Ibbotson data. In *Estate of Deputy v. Commissioner*, T.C. Memo 2003-176 (June 13, 2003), the decedent's business manufactured fishing boats. In formulating their discount rates, the experts for the estate and the IRS used similar premiums for the first three components, but vastly different company-specific premiums.

The estate's expert used a 3 percent premium based on six general categories, including the fact that the business was a small company. The IRS expert used a negative 5.2 percent premium based on Ibbotson's negative 5.2 percent premium for the ship and boat building industry. The IRS expert further compared some betas of comparable publicly traded companies and found that they supported the Ibbotson data.

Ultimately, the court ruled in favor of the IRS expert's negative premium on the basis of his analysis of publicly held companies and the tendency of the business to outperform the industry and economy. The court found the estate expert's premium to be subjective and lacking support.

This case provides support for the use of the Ibbotson industry risk data. The court may have deferred to this source as it was clear the court was not comfortable with the more subjective approach used by the estate's expert. In developing risk premiums, business appraisers would be well advised to consider the Ibbotson data in the analysis.

David F. Helms, CPA is the business valuation manager and John W. Toney is an associate in the Valuation and Litigation departments of Wallace, Delury & O'Neil, Inc. in Sacramento.

Economic Damages

by Troy Dahlberg, CPA
and Peter Brown, CPA

Recent U.S. Supreme Court rulings provide new guidance on the calculation and determination of punitive damage awards. In *State Farm Automobile Insurance Co. v. Campbell*, No. 01-1289, the Court overturned a $145 million punitive damage award stating it was not reasonable in light of the $1 million compensatory damages award.

The *State Farm* decision provides guidance for determining awards for punitive damages. Writing for the majority, Justice Anthony Kennedy noted that "… few awards exceeding a single-digit ratio between punitive and compensatory damages will satisfy due process." He implies a maximum ratio of nine to one between punitive and compensatory damages. The opinion also stated that for cases in which compensatory damages are substantial, a lesser ratio of punitive damages may be appropriate.

Since *State Farm*, the Court has vacated and remanded several punitive damages awards, including two against Ford Motor Company: *Ford Motor Co. v. Romo*, No. 02-1097, with awards of $5 million in compensatory damages and $290 million in punitive damages, and *Ford Motor Co. v. Estate of Tommy Smith*, No. 02-1096, with awards of $3 million in compensatory damages and $15 million in punitive damages.

It now appears that the Court is signaling its disapproval of large jury verdicts as punishment for company conduct.

Troy Dahlberg, JD, CPA, ABV is chair of the Economic Damages Section and leads Ernst & Young's Global Investigations & Dispute Advisory practice in the Pacific Southwest.

Peter Brown, CPA, ABV is a senior manager in Ernst & Young's Global Investigations & Dispute Advisory practice in Los Angeles.

Family Law

by David S. Cantor, CPA

Because of the market decline in recent years, CPAs are being asked: "How much would Mr. and Mrs. Smith have today if Mr. Smith had invested $25,000 in AAA bonds instead of investing the money in the ABC Partnership … which is now bankrupt?"

In *Marriage of Duffy* (2001) 91 Cal.App.4th 923, 111 Cal.Rptr.2d 160, the Court of Appeal was asked to determine to what extent one spouse has a fiduciary duty to the other spouse when it comes to investing. The Court decided that "[i]n short, a spouse generally is not bound by the Prudent Investor Rule and does not owe to the other spouse the duty of care one business partner owes to another."

However, effective Jan. 1, 2003, the Legislature amended Family Code Sec. 721 (Sec. 721) with the passage of SB 1936. Sec. 721 now includes reference to Probate Code Sec. 16047, which is part of the Uniform Prudent Investor Act. While it appears that the intent of the amendment was to impose stricter fiduciary duties between spouses with community investments, now it is possible that every investment decision made by one of the spouses can come under scrutiny from the other spouse.

There ultimately may be more changes to Sec. 721 to clarify the fiduciary duties between spouses, so keep an eye out for future published cases or changes in legislation related to this important issue. In the meantime, you still may be called upon to make that "what if" calculation, using 20/20 hindsight, in reviewing financial investments that were made during marriage.

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

Fraud

by Marie Ebersbacher, CPA

The July Fraud Section meeting in Los Angeles was another event full of timely and relevant topics. If you are a forensic accountant or an auditor who is interested in best practices for implementing SAS 99, attending section meetings is a great way to stay current on the issues affecting your practice.

Dale Hudson, attorney at Nixon Peabody LLP in Costa Mesa discussed the Fair Credit Reporting Act (FCRA). The FCRA is as important to CPAs investigating fraud as understanding the capitalization rate is to business valuation professionals. Simply put, if you do not have a thorough and current understanding of the FCRA, you are putting yourself at risk. Hudson also emphasized the distinction between the FCRA and the California Investigative Consumer Reporting Agencies Act. Keep an eye out for pending federal legislation (HR 1543 and HR 2622) that may change the way practitioners conduct employee investigations.

Nina Yamamoto of the U.S. Securities and Exchange Commission (SEC) discussed SEC activities related to financial fraud, including current enforcement trends. The SEC's focus includes prompt investigations, increased accountability for noncooperation, and coordination with criminal authorities.

In fiscal year 2002, the SEC investigated 598 cases, with the largest category involving financial fraud and issuer reporting; 163 actions were filed, continuing an upward trend. Yamamoto also reviewed red flags frequently found in accounting records and the management environment of suspect organizations.

The afternoon was dedicated to discussing forensic procedures in an audit environment, including current curricula for future CPAs and what firms are doing or planning to do to incorporate SAS 99 and Sarbanes-Oxley Act requirements.

Marie Ebersbacher, CPA, ABV, CFE is secretary of the Fraud Section and is a manager in the Litigation and Valuation Services department of Mayer Hoffman McCann P.C. in Bakersfield.

Message from the Chair

by D. Paul Regan, CPA

Our most recent steering committee meeting was held in Burlingame Aug. 13. The agenda covered a number of issues that are important to the way we practice litigation services, including an in-depth case study involving Corporations Code Sec. 2000, a presentation on revenue recognition accounting issues, and a discussion of the AICPA's Exposure Draft, *Proposed Statement on Standards for Valuation Services*.

A task force was established to summarize the steering committee's thoughts on the Exposure Draft into a letter to be sent to the AICPA for its consideration. I want to thank Rob Wallace, Brian Brinig, Jeff Kinrich, and Roger Wilde for their efforts assembling a terrific summary of comments.

The steering committee's letter was sent to James Feldman, AICPA manager of business valuations and litigation support services. The principal areas of concern detailed in the letter were:

1. We requested that the AICPA reconsider issuing these standards until it has finalized its potential exit strategy for the business valuation practice area.
2. If the AICPA abandons the ABV credential by implementing one of its exit scenarios and issues standards on business valuation, it should avoid inconsistencies with the standards of the valuation organization(s) with which it or its members may align.
3. We encouraged the AICPA to eliminate purported standards that are actually how-to rules that are overly specific with respect to the valuation process.
4. We strongly urged the AICPA to consider, and specifically address, the applicability of proposed valuation standards to valuations performed for litigation purposes and the unique needs of the litigation process.

We also discussed the draft of the AICPA's Family Law Practice Aid that Family Law Section chair David Cantor responded to on behalf of the steering committee.

In addition, the steering committee is in the process of forming a technical response team to allow the Litigation Sections to quickly respond to urgent litigation practice area issues. More to follow.

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

Performing a Solvency Analysis

by Mark Hayden, CPA, Ivan Lehon, CPA, and Richard Lee, CPA

Over the past several years, as corporate bankruptcies have become larger and increasingly complex, CPAs often are called upon to provide accounting and financial advice to debtors, creditors, and other interested parties. One common bankruptcy-related service that CPAs can provide is a solvency analysis. This article outlines the generally accepted methodologies used to provide a solvency analysis.

Parties to a bankruptcy use solvency analysis to determine whether or not a debtor was insolvent at points in time prior to its bankruptcy filing. If the debtor was insolvent before filing, but made certain transfers anyway, the transfers may be "avoided" (*i.e.*, treated as void) to equitably distribute the assets among the creditors. A solvency analysis may be necessary to defend against allegations of preferential payments and fraudulent transfers.

> ***With the increase in business bankruptcies over the past several years, trustees and other interested parties have demanded many more solvency opinions in an attempt to limit liability.***

U.S. Bankruptcy Code Sec. 547 (Sec. 547) defines preference payments and delineates the elements necessary to avoid transfers of a debtor's property interest. One of the elements is that the debtor was insolvent at the time of the transfer. Under Sec. 547, the debtor is presumed insolvent if a transfer is made within 90 days of the bankruptcy petition filing. Generally, a finding of insolvency is necessary if a transfer is made any earlier than 90 days.

Sec. 548 of the Code defines the tests for determining whether or not a transfer of the debtor's property interest is fraudulent, and therefore, avoidable. Transfers are fraudulent if the debtor either intended to hinder, delay, or defraud creditors, or the debtor unintentionally took part in a transfer, while insolvent, and did not receive "reasonably equivalent" value in return for the transferred property.

Solvency Analysis

A solvency analysis determines, at the time of the transfer, if: 1) the debtor's assets exceeded its liabilities, 2) the debtor could pay its debts as they came due, and 3) the debtor was not left with unreasonably small capital.

For a solvency analysis, the CPA collects relevant financial documents, such as historical financial data, projections, business plans, and industry outlooks. The CPA analyzes the information and interprets the relevant facts to make a conclusion about the debtor's financial condition at the time of the transfer. In certain situations, the CPA should restate the historical financial statements to be in accordance with generally accepted accounting principles (GAAP) as a result of management's failure to adhere to those standards. That restatement requires an understanding of GAAP, as well as forensic accounting skills that the CPA generally possesses.

There are three tests that, taken together, lead to a finding of solvency: 1) the balance sheet test, 2) the cash flow test, and 3) the adequate capital test. The debtor is considered insolvent if it fails any one of these tests.

Balance Sheet Test

The balance sheet test determines whether the debtor's assets exceeded its liabilities on the transfer date. It is an assessment of the fair market value of the debtor's assets and the face value of liabilities, including contingent liabilities. After determining the assets' fair market value, any debt is subtracted and other necessary adjustments are made to determine the debtor's equity value. The debtor passes this test if it has positive equity value.

Cash Flow Test

The cash flow test analyzes the debtor's expected future cash flows as of the transfer date to determine whether or not it has the ability to pay its debts as they come due. The CPA forecasts cash flow based on projections prepared by the debtor or a third party, such as the debtor's accountant. It is essential that these projections be reasonable and created by the debtor or third party before the transfer date that gave rise to the dispute.

This test seeks to determine if the debtor has the ability to repay its debts at various future dates (*i.e.*, its liquidity). To calculate liquidity, the CPA derives from the projections: 1) unreserved cash on hand, 2) free cash flows, and 3) available borrowing capacity. A debtor passes this test if it can pay its debt in each future period with available cash on hand, free cash flows, or additional borrowing. If additional borrowing is needed to pay debts as they come due, the debtor must do so without violating existing loan covenants.

Adequate Capital Test

The adequate capital test seeks to determine if the debtor has reasonable capital to run the business after the transfer. Unlike the cash flow test,

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