AICPA Alert

by Ann E. Wilson, CPA

The AICPA's Litigation and Dispute Resolution Services Subcommittee (LDRS) has not met since our meeting in Miami in February; however, we held a conference call on April 23. The conference call addressed the LDRS agenda for the upcoming year.

The LDRS continues to work on its Strategic Plan for 2004 (Aug. 1, 2003–July 31, 2004). One aspect of the plan is to create, develop, and promote awareness and demand for CPA experts and litigation consulting services to the legal community. As part of this effort, the LDRS will have a booth at the American Bar Association Annual Meeting in San Francisco Aug. 7–10. Twelve thousand lawyers are expected to attend this event. If you are interested in helping staff the booth on one of these days, please contact me at *ann@aewilsoncpa.com*.

The second draft of the *Statement on Standards for Valuation Services No. 1* is now being edited. It will be sent out for another informal round of comments. The public exposure draft is expected to be sent out by Aug. 1.

The LDRS has provided comments to the *Omnibus Proposal of Professional Ethics Division Interpretations and Rulings*, dated March 19, 2003.

The LDRS is considering changing its name to better reflect the scope of services provided by litigation practitioners. This will be discussed at the next meeting in late July in St. Louis. If you would like to suggest a possible new name for LDRS, please send it to me at my e-mail address noted above.

The LDRS has instituted an award for volunteer service. The recipient will be announced at the Advanced Litigation Services Conference in Miami Oct. 1–3.

The Family Law Task Force, under the leadership of Sharyn Maggio, has written a family law practice aid. It is scheduled to be published and available by the end of July.

The AICPA is in the process of developing strategic plans for each of the credentials it currently offers. The plans will be presented to the AICPA Council at its next meeting in October.

A discussion paper outlining key areas of the Sarbanes-Oxley Act of 2002 that affect litigation practitioners is available online at *www.aicpa.org*.

The BV/LDRS Competency Model assessment tool is still under development. Its implementation has been delayed until the business valuation standards are finalized.

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Keepin' It Legal

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larger the company, the greater its ability to pay.

Competitive standing can also weigh in on the pay scales. Generally, among similar-size companies, uniform levels of salaries tend to prevail. Large market share companies, on the other hand, tend to pay higher salaries to maintain their position in the marketplace. Smaller companies sometime have to offer very desirable compensation packages to attract knowledgeable people, thus driving up the going rate.

Finally, operating results can also affect salaries. Very simply, in tough times companies tend to pay less than in highly profitable times. The appraiser should consider the effect of operating results, with an understanding of industry and economic cycles that affect the business.

External Compensation Comparison

Determining replacement compensation also requires that the appraiser compare compensation of similarly positioned companies. For a company to be comparable, it must be a meaningful and relevant comparison, but it does not have to be a perfect comparison.

External comparison has become easier in recent years. Compensation studies can be accessed via the Internet; however, these studies should be used with care. Before relying on any given survey or study, the appraiser should determine the survey's source of information, as well as the quality of the methods and the quantity of the data used in the survey.

Executive search firms can serve as another useful source of information.

Individuals with experience in assisting the subject company in its financial affairs can be an excellent source of meaningful relevant data. CPAs and other professionals who counsel companies and prepare financial statements and tax returns can offer valuable insight about a company's history, operating characteristics, and industry. Often the company seeks the CPA's advice in setting levels of compensation.

Company Compensation Program

Before gathering replacement data, the appraiser should understand the financial arrangements among the company's owners. Base salaries with bonuses based on profit might indicate that base levels are replacement levels. It depends, however, on the facts and circumstances in each case. The appraiser should review the compensation program for consistent application.

Summary

An analysis of replacement compensation involves a proper understanding and consideration not only of the job functions necessary for the position being evaluated, but of other characteristics of the company as well, including its industry, location, and comparability within the industry in which it operates. The appraiser should gather or adjust data so that the reasonable compensation conclusion derived represents information as close to the locale of the subject as possible.

Donald Miod, CPA, ABV, CVA, CBA is a former chair of the Family Law Section and is founding partner of Miod and Company LLP in Palm Desert.

HAPPENINGS

Litigation Sections Meetings

Business Valuation	Thursday, Sept. 18, OAK
Economic Damages	Wednesday, Oct. 22, SF
Family Law	Friday, Sept. 19, OAK
Fraud	Tuesday, Oct. 14, LAX

Each section will send individual meeting notices.

Education Foundation Course Offerings—(800) 877-5897

Business Valuation Overview	Wed., Sept. 24, LAX
Business Valuation & Succession Planning: A Practical Approach	Wed., Oct. 8, LA/Bev.Hills
Family Law Workshop	Thurs.–Fri., Oct. 2–3, SF
Fundamentals of Business Valuations: Part I	Mon.–Wed., July 28–30, LA/Bev. Hills
Fundamentals of Business Valuations: Part II	Mon.–Wed., Aug. 25–27, LA/Bev. Hills
Litigation Consulting: Essential Skills for Staff and Others	Mon., Sept. 29, SF

Opportunities

Continued from Page 1

tained in electronic form, such as e-mails and files contained on computer hard drives and shared network drives. The CPA should also consider whether it may be necessary to mirror information from the company's accounting system such as the general ledger and disbursement journals. The gathering and cataloging of information should be carefully coordinated with counsel to make sure that information is readily accessible in case there are requests from third parties, such as the SEC or the U.S. Department of Justice (DOJ).

If a restatement is suspected to be the result of misconduct, the SEC Enforcement Division has the authority to investigate. The SEC can levy a variety of penalties against companies and individuals, including monetary sanctions and cease-and-desist orders, as well as barring individuals from serving as officers or directors of publicly held companies. The SEC can also refer matters to the DOJ for criminal prosecution.

In October 2001, the SEC announced that it was taking no action against a company that had materially misstated its financial results due to erroneous entries deliberately misclassified by a former controller. The decision was announced in Exchange Act Release No. 44969, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*. In it the SEC identified criteria that it will consider in determining the enforcement actions, if any, to be taken against a company that is making financial restatements.

The SEC's criteria consist of a series of questions intended to provide the SEC with an understanding of a company's efforts in the areas of self-policing, self-reporting, remediation, and cooperation. Many of these questions involve items that the CPA should address during the course of the investigation. For example, the SEC will want to know what types of controls the company had in place at the time the restatement-related transactions occurred and what role those controls, or lack thereof, played in identifying the restated transactions. Communicating this type of information along with what steps the company has taken to remedy the conditions that led to the restatement may result in lighter sanctions or, in certain extraordinary cases, no enforcement action at all.

Cognizance of the SEC's criteria and a timely and thorough investigation conducted by a qualified and independent CPA can help the financial restatement process go smoother and result in less dire consequences.

Jose A. (Tony) Santana, CPA is a managing director with FTI Simpson in Los Angeles.

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The Witness Chair

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

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Financial Restatement Investigations Present Opportunities for CPAs

by Jose A. (Tony) Santana, CPA

The quantity and dollar amounts associated with public company financial restatements have increased dramatically in recent years. This has resulted in increased enforcement actions by the Securities and Exchange Commission (SEC) and new legislation, primarily the Sarbanes-Oxley Act of 2002. CPAs with training and experience in conducting forensic investigations can assist in guiding a company through the critical time between the identification of the problem and the restatement of the financial statements. A timely and thorough investigation can minimize the loss of shareholder value that usually follows the announcement of a potential restatement.

In assessing the initial scope of the investigation, the CPA should gain an understanding of the nature and dollar value of the transaction or transactions at issue. This involves becoming knowledgeable about: 1) the process by which the transactions were initiated, approved, and recorded, 2) the departments and individuals involved at each step, and 3) other types of transactions that the departments or individuals may have been involved with. Addressing these issues should assist the CPA in developing an initial understanding of the magnitude of the potential restatement. It should be made clear that this initial understanding is preliminary and subject to revision, since the company may decide to include this range in its public releases.

There are several factors that can lead to situations where financial statements are misstated. For example, certain individuals within the company may be under pressure to meet quarterly earnings expectations or incentive compensation targets, and may deliberately falsify financial information. Also, situations involving complex corporate financing arrangements, where accounting treatment requires difficult interpretation, can result in erroneous accounting and inadvertent misstatement of financial statements. The CPA should understand what role, if any, these factors played in the initial recording of transactions so that the company and its board of directors can make decisions regarding the continued employment of the individuals involved.

> *… CPA can help the financial restatement process go smoother and result in less dire consequences.*

The CPA should also consider the adequacy of the procedures utilized by the outside auditors with regard to restated transactions. This also involves considering whether there were deliberate attempts to mislead the auditors by company officers or employees. Ideally, these tasks should be accomplished through a review of the audit work papers and interviews of the auditors. If neither the auditors nor their work papers are available, attention should be focused on analyzing those documents which the company made available to the auditors during the course of the audit.

Attention should be given at the early stages of the investigation to identifying the various types and locations of information that will be necessary. Information should be gathered as quickly and comprehensively as possible while attempting to minimize the disruptions to the company's day-to-day operations. The company should communicate to its employees that potentially relevant documents are not to be destroyed or withheld from investigators.

Special expertise may be necessary to gather information that is main-

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In this Issue

Section ACTION

Business Valuation

by Robert Wallace, CPA

A recently decided Tax Court (Court) case, *Estate of Albert Strangi* (T.C. Memo. 2003-145, May 20, 2003), has important implications for those involved in the formation, structuring, and valuation of a family limited partnership (FLP).

The FLP was funded with about $11 million, representing 98 percent of the decedent's wealth. The decedent held a limited partnership interest in the FLP, as well as a 47 percent interest in the FLP's corporate general partner. A discount of approximately 40 percent was claimed.

The issue before the Court was not the valuation discount, but whether the decedent retained certain rights during his lifetime that would require inclusion of the transferred assets in the gross estate under IRC Sec. 2036.

The Court, upon remand from the Fifth Circuit, ruled that the full value of the transferred assets, without discount, must be included in the gross estate of the decedent and that both Sec. 2036 (a) (1) and 2036 (a) (2) applied.

The Court had some unusual facts which were critical to the government's arguments and the Court's decision. The decedent had provided his son-in-law with a general power of attorney. This ultimately led to the Court's finding that IRC Sec. 2036 rights were retained. The Court was also influenced by the fact that the FLP held virtually all of the decedent's assets, supporting a finding of an implied agreement for the retained possession during lifetime.

Rob Wallace, CPA, JD, ASA is the Business Valuation Section chair and is a principal with Wallace, Delury & O'Neil, Inc. in Sacramento.

Economic Damages

by Susan Bleecker, CPA

Energy Capital Corp. v. United States, 302 F.3d 1314 (Fed. Cir. 2002) includes several findings and cites of note to CPAs who calculate economic damages.

The rulings in this case allowed for the recovery of lost profits of a new venture not previously performed by a business. It also determined that the amount of lost profits was properly discounted to the date of the judgment (not the date of the breach of contract) and that a risk-adjusted discount rate should have been used to calculate the present value of the damages.

The U.S. Court of Federal Claims found as a matter of fact that Energy Capital had established causation, foreseeability, and reasonable certainty of damages, and the U.S. Court of Appeals (Court) affirmed this ruling, thus allowing for lost profit damages, regardless of whether the venture was new or an extension of an existing business. In its discussion, the Court cited Robert L. Dunn's *Recovery of Damages for Lost Profits* in making its finding.

Several cases were cited as to the determination of when the lost profits were to be discounted, holding that the lost profits at issue in this case were to be discounted to the date of judgment.

The case includes a lengthy discussion of risk-free vs. risk-adjusted discount rates, stating that the Court does "not hold that in every case a risk-adjusted discount rate is required. Rather, [the Court] merely hold[s] that the appropriate discount rate is a question of fact." After a discussion that included several excerpts from Robert Dunn and Ev Harry's article printed in the January 2002 *Journal of Accountancy*, the Court determined that the appropriate discount rate in this case was 10.5 percent based on the evidence presented by both parties.

Susan Bleecker, CPA is editor of The Witness Chair. *Her practice is based in Pasadena.*

Family Law

by David S. Cantor, CPA

Keep good files and records—it may someday save your assets. Maintaining good files enables CPAs to provide quality service to clients and may also result in providing themselves with good service.

The California Court of Appeal (Court) made certain findings in *Orrick Herrington & Sutcliffe v. Superior Court (*2003) 107 Cal.App.4th 1052. In short, when a client sues, the case-within-a-case method must be used to establish malpractice. In this specific case, the action was brought by a client against his family law attorney claiming malpractice in negotiating an out-of-court settlement. The Court ruled that the client must establish that if not for the alleged incompetent advice provided by the attorney, the opposing side would have settled for less or the client would have obtained more favorable results at trial.

Many times during settlement negotiations, the client and the attorney look to the accountant for guidance in settling cases. The role we play may have a significant impact on the client's ultimate decision.

So what happens when the client refocuses its vengeance from the ex-spouse to the attorney or CPA expert? Even though the burden falls on the client to prove their case, taking certain steps throughout the engagement will benefit not only the client, but also the CPA. Make sure to document in your files all of your conclusions. If you are unable to reach conclusions due to insufficient records, notify the attorney on the case as soon as possible that you are unable to complete parts of your assignment and what circumstances prevent you from completing your assignment.

By accumulating good files, notes, and records, you will provide both your client and yourself with quality service.

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

Fraud

by Daniel W. Ray, CPA and Stuart H. Harden, CPA

The AICPA Litigation and Dispute Resolution Services Subcommittee's Fraud Task Force is preparing a discussion paper to provide guidance to practitioners in applying forensic procedures in an audit environment. This will assist external auditors, internal auditors, and forensic accountants in complying with the provisions of *Statement on Auditing Standards No. 99: Consideration of Fraud in a Financial Statement Audit* (SAS 99). The paper will discuss the professional standards that apply when forensic procedures are employed in an audit and explains, among other things, the various means of gathering evidence through the use of forensic procedures and investigative techniques.

With respect to SAS 99, Chuck Landes, AICPA Director of Audit and Attest Standards, stated "[The AICPA] feel[s] strongly that the standard will substantially change auditor performance, thereby improving the likelihood that auditors will detect material misstatements due to fraud." As the public continues to expect that audits be designed to detect fraud, auditors still maintain that the intent of an audit is not for that purpose. However, in light of the recent provisions under SAS 99, an auditor now must conduct forensic procedures along with traditional auditing procedures. This includes an exchange of ideas or brainstorming among the audit team members about how a fraud may occur within each specific audit engagement.

As the traditional audit begins to incorporate more characteristics of a forensic or fraud investigation, the auditor may be confronted with a multitude of complex issues. Since the primary purpose of an audit is not to detect fraud, auditors do not always have the specific training to perform such tasks. Additionally, the restrictions imposed by the Sarbanes-Oxley Act of 2002 may prevent the auditor from conducting a financial investigation.

If the auditor determines during the course of the audit that indicia of fraud appear to exist, the audit may lead to a separate forensic or fraud investigation. Footnote 2 to SAS 99 states that when forensic accountants are requested to perform "other services related to fraud detection and prevention," these usually include procedures that extend beyond or are different from those ordinarily performed in financial statement audits in accordance with GAAS, and that different professional standards apply.

This forthcoming discussion paper will be a key tool in bridging the gap between the traditional audit and a forensic or fraud investigation. Narrowing the existing gap between the public's and the profession's expectations is a top priority.

Dan Ray, CPA, CFE, CIRA and Stu Harden, CPA, CFE are directors in the Litigation Services Group of Hemming Morse, Inc. CPAs, Litigation and Forensic Consultants in San Francisco.

Message from the Chair

by D. Paul Regan, CPA

The steering committee's May 7 meeting in La Quinta had a full day of case studies and discussions of professional activities that impact our practices. The two-day Advanced Business Litigation Institute followed.

At the steering committee meeting, we were fortunate to have Bruce Deal as a presenter. Bruce is with Analysis Group and was one of the consultants who was directly involved in *Trigon Insurance Co. v. United States*, 204 F.R.D. 277 (E.D. Va. 2001). He shared with us his experiences and conclusions regarding the case and the opinions of Judge Payne.

Steering committee member Ev Harry presented an analysis and led a discussion on *Energy Capital Corp. v. United States*, 302 F.3d 1314, a recently decided Court of Appeals case (see Economic Damages column, page 2). The opinion cites the article that Ev and Robert Dunn wrote for the *Journal of Accountancy* that was published in January 2002. This article is an excellent discussion of modeling and discounting future damages.

Steering committee member Andy Mintzer co-chaired the California CPA Education Foundation's (Foundation) Advanced Business Litigation Institute with Andy August, Esq., a partner at the Pinnacle Group in San Francisco. Many Litigation Sections members were speakers at this conference, and we are particularly grateful to Henry Stotsenberg and The Stotsenberg Foundation, as well as the Pinnacle Group, for their generous sponsorship. Their sponsorship enabled us to enjoy lunch on both days and afforded us the privilege of hearing Leslie Caldwell, JD, Director of the Enron Task Force for the U.S. Department of Justice in Washington, D.C. as our lunch speaker.

The Litigation Sections worked with the Foundation to plan the Institute, which offered high-quality CPE. If you were unable to attend this year, do not miss the next one.

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

Keepin' It Legal

Reasonable Compensation and Replacement Compensation in Business Valuations

by Donald John Miod, CPA

In the world of business valuation, one of the elements of value is the compensation to the person(s) operating the business. This article discusses the terminology and explores the elements necessary to determine reasonable or replacement compensation.

Valuation Formulas

Earnings of a business available in excess of compensation appropriate for running the business have value, and the task of valuation experts is to convert those earnings into a dollar value. Some of the valuation formulas requiring a determination of reasonable or replacement compensation are:

- The excess earnings method
- The capitalization of earnings method
- Industry-specific rules of thumb

Reasonable Compensation

Business owners usually consider their salary reasonable for what they do. However, if you ask the same owners what they would pay a replacement owner, you will probably get a different answer.

When discussing reasonable compensation, the real issue is replacement compensation. The appraiser must determine the amount of money necessary to replace the owner of a business for the services he or she renders.

Terminology

Business valuation terminology has a number of different terms to describe the value associated with "reasonable compensation," including:

- Replacement compensation
- Fair value of owner's services
- Value of owner's services
- Owner's replacement compensation
- Operator compensation
- Cost to replace operator

Regardless of the terminology used, the real meaning conveyed is the cost to replace the owner. To simplify, this article uses the term "replacement compensation" to convey all of the foregoing concepts.

Replacement Compensation Considerations

To evaluate an owner's compensation for any given valuation, the appraiser should consider the following:

- The owner's role and responsibilities in the company
- The industry in which the business operates
- The location of the business
- The company character and condition
- External compensation comparison
- Company compensation program

Owner's Role and Responsibilities in the Company

Probably the most fundamental element in the search for replacement compensation is the owner's responsibilities, and, therefore, documenting these in a job description is important. Determining the owner's job description should be the appraiser's first step. The job description should include all of the functions necessary to perform the job duties, as well as the educational background and work history for the person currently serving in the position.

The task of determining replacement compensation should include defining the highest-level functions necessary for the position. For example, a current job description for the CEO of a high-tech company might include customer relations duties requiring a degree in engineering. The CEO's job responsibilities also might include routine functions such as purchasing office supplies. Because the routine functions could be delegated, compensation data should be gathered for the highest level of skills required for the job, that is, the engineering degree.

Industry in Which the Business Operates

To understand a particular business and its compensation practices, the appraiser should examine the industry in which the business operates. For example, a company in a cyclical industry might employ different compensation practices than one in a more stable industry.

In addition, certain industries simply prefer particular forms of compensation. For example, some industries make liberal use of stock options as a major part of a compensation package, while others tend to favor bonus programs to create a productivity incentive.

Location of the Business

The location of a business can affect compensation due to its geographic proximity to commerce and the regional quality of life and cost of living. For example, a person located in Idyllwild performing the same function as a person running a business in Beverly Hills probably will receive a different compensation package. Housing costs alone can significantly affect how much a company must pay to attract and retain employees. The Silicon Valley aptly demonstrates this phenomenon.

To capture the influence of location, the appraiser should gather replacement compensation data for the area nearest to the business's location. More distant companies may require adjustments to bring the data in line with the local environment.

Company Character and Condition

Key elements in a company's character and condition include its size, industry, location, competitive standing, and history of operating results. Industry and location have already been discussed.

A company's size, as measured by total sales, will affect its ability to attract and retain employees. In general, the

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