THE Witness Chair

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

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Discount Rates and Lost Profits ... Where's the Risk?

by Craig M. Enos, CPA
and Greg Regan, CPA

When calculating lost profits in commercial damage cases, future profits should be discounted at a rate that fairly compensates the plaintiff. Since the goal is to make the plaintiff whole, the plaintiff should receive an amount at the date of judgment that can be invested over the period of future loss and yield the plaintiff the amount of the lost profits.

So, what does this objective necessitate? One common method to compute damages is the three-column approach. In this analysis, the actual scenario is compared to the "but-for" scenario and the difference is the quantification of the damages. If any portion of the damages occurs in the future, at a minimum, a discount rate should be applied to take into consideration the time value of money. However, the bigger challenge for the CPA is to address the risk that the damages would have been realized in the "but-for" scenario. Accordingly, the CPA must consider whether or not:

1) The damages analysis incorporates sufficiently conservative assumptions so that the discount rate is reflective only of the time value of money;
2) The damage model leaves a residual amount of risk that should be addressed via a relatively higher discount rate; or
3) The model should be left unadjusted with all risk included in the discount rate.

In their article in the January 2002 *Journal of Accountancy*, "Modeling and Discounting Future Damages," Robert Dunn and Everett Harry analyzed these competing methods to address risk in the calculation of lost profits. These approaches can be summarized as adjusting for risk via the income stream or through the discount rate itself. While this and other related articles should be consulted for a more in-depth analysis of this issue, in essence the first approach involves applying a reality check to the plaintiff's "hoped-for" income stream. Once the "hoped-for" income stream has been adjusted to the "best estimate," the analysis no longer requires as great a risk premium as part of the discount rate and a relatively low discount rate may be applied. The second accepted approach leaves the "hoped-for" income stream unmodified. Instead, the discount rate includes a commensurately higher degree of risk to determine present value.

> "Ultimately, the appropriateness of a discount rate will depend on the theory to which the user subscribes ..."

The advantage of the first approach is transparency. Supporters argue that factoring risk directly into the income stream is easier for triers of fact to understand. While the CPA analyst understands the resulting volatility that alternative discount rates can generate, it is less likely for a judge or jury to be in the same position. Supporters of the second theory argue that the correct method is to project the "hoped-for" income stream and then account for risk by applying a risk-adjusted discount rate. Similar methods are accepted for business valuation purposes where more comparable data may exist with respect to discount rates.

Ultimately, the appropriateness of a discount rate will depend on the theory to which the user subscribes and may vary given the particular circumstances of a matter. In practice, discount rates range from the rate of return on a Treasury bond for a secure income stream to an equity rate of return for an income stream that has greater risk. In *Schonfeld v. Hilliard*, 62 F.Supp 2d 1062, 1074 n. 6 (S.D.N.Y. 1999), an 8 percent discount rate, the rate of the 10-year U.S. Treasury bond, was accepted by a court related to a loss of $100,000 per year for a 10-year contract. In contrast, in another breach of contract case, *Fairmont Supply Company v. Hooks Industrial, Inc.*, No. 01-03-01129-CV (Tex. App. 1 Dist [Houston] 2005), a court accepted the range of 33 percent, presented by the plaintiff's expert, to 36 percent, presented by the defendant's expert. Assuming the same $100,000 10-year stream of cashflows was at stake, the first court would have awarded approximately

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Section Action

Business Valuation
by Scott T. Dye, CPA

Since the AICPA *Statement* *on Standards for Valuation Services No. 1* was issued last year, much has been written about the use of a calculation engagement as opposed to the valuation engagement. Generally, the discussion focuses on the inability to use the more limited calculation engagement in a litigation setting. If the procedures used in the engagement are limited, the valuation analyst cannot form an opinion nor testify to a "conclusion of value," which is what the client needs in litigation.

There are a number of possible uses for a calculated value result in a calculation engagement, versus a conclusion of value result in a valuation engagement, which will be beneficial to clients. Given proper knowledge of the client and valuation methodologies and procedures, the calculated engagement can be an effective planning tool to develop an estimate of value for estate and gift purposes, sales negotiations and potential damages when providing consulting services.

It is also possible that there is a use for the calculated value in litigation for rebuttal. Using reasonable assumptions from the opposing analyst's report, calculating the value using a different discount rate, accounting adjustment or some other point of contention would probably give a "calculated value" under the standards. If the analyst can give expert testimony as to why the change was appropriate, it could stand up in court and save both time and money. This approach may be useful when brought in late or given a limited budget.

Before telling a client there is no alternative to providing a "conclusion of value," give a "calculated value" some thought. It just might fit the given circumstances.

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

Economic Damages
by Christian D. Tregillis, CPA

After patent reform legislation passed the U.S. House of Representatives in 2007, the Senate bill has stalled following substantial resistance from a variety of groups. S.1145 has been taken off the schedule, and while it could be revived at a future date, the bill has drawn opposition at nearly every step, so its passage likely will remain a challenge.

The House and Senate bills broadly resemble the proposed Patent Reform Act of 2005, which would have enacted many of the proposals recommended by a 2003 Federal Trade Commission report and 2004 National Academy of Sciences report. Given the recent trend in large damage awards (notably in situations in which plaintiffs are non-practicing inventors), a key and hotly debated element of the legislation is in the area of damages. Under the proposed legislation, damages would be explicitly proportional to the actual value of the infringing item. This issue is part of the *Georgia-Pacific* and *Panduit* analyses under the current system, but its explicit and strong identification in the proposed bills would likely reduce future damage awards—which some see as weakening the value of U.S. patents.

As things stand, the Patent Reform Act's slow progress has been a lesson in the challenges this sort of legislation faces. After the House passed a version of the bill last year, the Senate was slow to introduce its version of the bill. Although it was introduced by a bipartisan group of eight sponsors, it has yet to make it out of the Judiciary Committee, where its presence has set off an apparently frustrating debate.

The stalling has not been a complete surprise. Some groups, including patent lawyers and pharmaceutical companies, are happy with the current system, and hope to see little change. Many technology companies hope to avoid exposure to catastrophic damages, while maintaining the value of their patent portfolios. Legislators undoubtedly are getting mixed messages from lobbyists, meaning they are likely to tread cautiously into patent reform. For now, the bill will need more time in the Judiciary Committee before it can be considered by the full Senate. As a result, those performing damages analyses should continue to look to the current Patent Act and case law on related issues when seeking guidance.

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

Family Law
by Lionel T. Engleman, CPA

Three major issues currently being discussed in our family law practices are:

- Business valuation standards of value;
- Disclosure issues, including Marriage of Feldman, and
- Personal vs. company goodwill.

The AICPA's *Statement on Standards for Valuation Services No.1* provides for two levels of opinion of value: conclusion of value and calculated value. In spite of its more limited procedures, using a calculated value in family law still may be an alternative, although at this point, most practitioners feel it is too risky. The questions being asked and issues discussed include:

1) Will the courts get involved in the issue, for instance, in terms of the weight of the testimony and opinion?
2) Does the size of the case and valuation matter—cost vs. benefit?
3) Will the access to documents and management have an effect?
4) What is the relationship of level of work as compared to other experts, including business brokers.

At each Family Law Section meeting, we plan to have short updates on practical issues relating to implementing the business valuation standard.

The area of disclosure in family law matters has not often been addressed in smaller to medium-sized cases. The attorney and CPA need to coordinate the information provided to and obtained by the CPA to meet the disclosure requirements. In our meetings,

we will continue to deal with this issue.

California is among the states that have slowly addressed the issue of personal goodwill, the separate property value of a provider of services. One goal of the Family Law Section this year is to match the current case law to the separation of personal and company goodwill. A task force has been started to review and summarize these cases and to determine the current trends and themes of goodwill.

Section members' opinions on professional ideas and solving potential client controversies have and continue to highlight our meetings. I am excited about what the Family Law Section will accomplish during the next two years. Please join us.

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

Fraud

by Jennifer E. Ziegler, CPA

The U.S. Supreme Court reversed the conviction in *Boulware v. United States* in March 2008. Boulware was the founder, president and major shareholder of a closely held corporation who was indicted in 2001 based on the allegation that he diverted approximately $10 million to his significant others. Boulware claimed that these funds were merely a return of capital that had been invested in the corporation and not income. Boulware was barred from presenting the return of capital theory to the jury and subsequently was found guilty on four counts of tax evasion and five counts of filing false returns.

There are three elements that must be established to be convicted of tax evasion:

- Tax was evaded;
- Tax was due; and
- The evasion was willful.

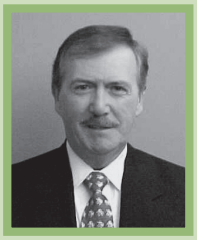
The Supreme Court examined the question of " … whether the diversion of corporate funds to a shareholder of a corporation without earnings and profits automatically qualifies as a non-taxable return of capital up to the shareholder's stock basis … even if the diversion was not intended as a return of capital." The Supreme Court concluded that if a corporation has no earnings or profit, a distribution should be treated as a nontaxable return of capital (up to the shareholder's basis in the stock).

As asserted by Boulware, if the funds were a return of capital, then there would have been no tax due. The Supreme Court agreed and stated that "tax classifications like 'dividends' and 'return of capital' turn on 'the objective economic realities of a transaction rather than … the form the parties employed." The Supreme Court reversed Boulware's convictions, stating that a defendant could not be convicted of tax evasion absent evidence of an actual tax deficiency. *Boulware v. United States* is significant and raises the real possibility that other defendants will defend themselves asserting that corporate distributions were a return of capital.

Jennifer E. Ziegler, CPA, CFE *is Fraud Section chair and a director at Hemming Morse, Inc. in Los Angeles.*

MessageFromtheChair

by Ronald L. Durkin, CPA



Change. We see this term used in the political arena and we see it all around us in the weather, stock market and in a variety of other settings. I see our Litigation Sections facing changes as well. Let's start with our leadership. As the new Litigation Sections chair, I am looking forward to working with you to meet the challenges that lie ahead.

We also face changes that will affect how the Litigation Sections leadership team moves forward. The newest change comes from the AICPA, which has approved the Certified in Financial Forensics credential. As practitioners who call ourselves forensic accountants, this will present us with new opportunities and challenges. The opportunities brought about by this change are subtle but I believe tremendous for those of us who practice in the litigation services area. All experts now will be challenged as to whether or not they are a forensic accountant and if they are, do they have the credential.

The change brought about by the credential also will require us to provide subject matter experts in business valuation, economic damages, family law and fraud to help build the curricula for these areas. Training will be an important part of implementing the rollout strategy.

Another change to report takes place on a personal level. I have announced my retirement from KPMG effective Oct. 1. I plan to move to San Diego and start my own forensic accounting firm there.

Another person who faces change with each incoming chair, is our CalCPA staff liaison, Maria Nazario. Maria has been a constant from year to year, and she has been consistently strong in her support of our leadership team. I want to thank Maria for all of her dedication and service to CalCPA and its Litigation Sections. I would hate to think where we would be without her.

In closing, I would like to thank our outgoing chair, Mark Luttrell, for all of his hard work and dedication to serving our litigation services community. Mark and the chairs who came before him always have exemplified what it means to serve. In my next column, I will discuss service and leadership, which I feel are critical to our success within CalCPA's Litigation Sections.

—**Ronald L. Durkin, CPA, CIRA** *is a partner and Western Regional Forensic Practice Leader at KPMG in Los Angeles.*

Keepin' It Legal

How to be Cloaked With Privilege

by Randall J. Dean, Esq.

In nearly every civil case, whether family law, personal injury or probate, the Court will order the parties to mediate the dispute before it allows the case to proceed to trial. Expert witnesses now play greater roles in mediation than in years' past as clients and counsel recognize that mediation is likely the best and last opportunity to resolve the case before "rolling the dice" and incurring significant fees for trial. Also, as complex financial issues are often too time-consuming and difficult for mediators to fully absorb and apply, experts now are more frequently used to assist the mediation process at the request of the mediator or jointly by the parties. Given this ever-expanding role of experts in mediation, understanding the law and use of appropriate engagement agreements is imperative to limit potential liability.

The laws in California governing mediation are found in the Evidence Code, Code of Civil Procedure and California Rules of Court. There is a wealth of statutory and common laws which, if effectively used, can nearly immunize experts active in the mediation process. For example, the term "mediator" under Evidence Code Sec. 1115 includes "any person designated by a mediator either to assist in the mediation or to communicate with the participants in preparation for a mediation." This would include an expert. Therefore, if retained by the mediator, the engagement agreement should state that the expert is serving as a neutral person as defined in Evidence Code Sec. 1115. With that simple language, the expert gains immense protection.

First, under Evidence Code Sec. 703.5, the expert/mediator cannot be called to testify in any subsequent proceeding as to any statement, decision, or ruling occurring at or in conjunction with the prior mediation. Essentially, the expert retained to assist the mediator can never be challenged in court for work if so appropriately designated in the engagement.

Likewise, if the expert is being used to actually render a decision that will be binding upon the parties, the engagement agreement should reference Civil Code Sec. 47(b), which grants privilege—in essence, immunity—for those actions in a quasi-judicial capacity. The use of this Civil Code section in such engagements should eliminate any possibility that a disgruntled litigant will blame the expert for an adverse result.

Inadmissable

Experts also should be cognizant of the fact that Evidence Code Sec. 1119 makes inadmissable, and not subject to discovery, any report that is prepared for the purpose of, or in the course of, a mediation hearing. Such writings may not be compelled in any civil action. Additionally, under this section, any communication or consultation in the course of mediation shall remain confidential.

Therefore, the experts' reports should be referenced as being prepared for mediation and intended to be covered by this Evidence Code section. If so appropriately designated, even if the report later proved to be wrong, it is arguably not admissible to establish liability. Also, if advice is given at mediation, it arguably cannot serve as the basis for later alleged liability if the advice later proved to be wrong. That would certainly be true if the engagement agreement references the fact that Evidence Code Sec. 1119 shall govern the reports and the expert's communications.

No Exceptions

Finally, in *Foxgate v. Bramalea California Inc.* (2001) 26 Cal.4th 1, the California Supreme Court held that there are "no exceptions to the confidentiality of mediation communications or to the statutory limits on the content of mediator's reports." Additionally, the court found that "while a party may do so, a mediator may not report to the court about the conduct of participants in a mediation session." In light of the Evidence Code provisions, and the public policy in favor of parties mediating disputes, the California Supreme Court held that both mediators and participants are prohibited from revealing any communication made during the mediation. Together, Sec. 1119 and 1121 "unqualifiedly bar disclosure of communications made during mediation absent an express statutory exception."

> "… the California Supreme Court held that both mediators and participants are prohibited from revealing any communication made during the mediation."

The California Supreme Court, just three years after *Foxgate*, again took up the issue of mediation and confidentiality in *Rojas v. Superior Court* (2004) 33 Cal.4th 407. The *Rojas* Court held that when taken together, Sec. 1119 and 1120 "establish that a writing … is not protected 'solely by reason of its introduction or use in a mediation,' but is protected only if it was 'prepared for the purpose of, in the course of, or pursuant to, a mediation." Thus, this case requires experts' reports to be so appropriately designated as for mediation purposes if privileges are to apply.

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AICPA Alert

by Christian D. Tregillis, CPA

As mentioned in Message from the Chair, the AICPA recently launched the new credential, Certified in Financial Forensics (CFF), which is designed to offer CPAs the premier credential in forensic accounting.

With increasing marketplace demand for financial investigations, some colleges have introduced classes in forensic accounting, and the field has received additional recognition in the press and the labor market. Historically though, CPAs and others who perform such investigations and analyses have not had a credential to demonstrate their depth of experience in forensic accounting and financial analysis.

A key benefit to credential holders and the marketplace is the ability to distinguish which CPAs are forensic specialists. This can be valuable to practitioners in their efforts to promote their expertise and qualifications, as well as for those who hire or evaluate forensic accountants and financial analysts, as they are now better able to identify professionals with the requisite experience and knowledge to obtain the credential.

To obtain a CFF one must first be a CPA member of the AICPA. Applicants also must obtain 100 "points". Points can be obtained through a combination of experience (5 years minimum), professional education and holding other credentials.

Though an examination is not part of the initial application process, the AICPA is considering introducing an exam in a few years. The AICPA is currently evaluating the sub-specialty areas that would be part of an exam, such as data forensics, accounting fraud, expert testimony and lost profits/damages, as well as how the exam would be implemented.

The annual fee for the credential is $350, which includes membership in the AICPA's Forensic and Valuation Services Section. For practitioners who already possess the Accredited in Business Valuation credential, the annual fee for the CFF is $200.

With the CFF, the AICPA will provide a strong value proposition to members by offering a credential that allows those who have unique and specialized knowledge and experience to make that better known to the marketplace. In addition, the Forensic and Valuation Services Section strives to provide practitioners with education, resources and tools to enhance practice efficiency and performance.

More detailed information about the new credential and how to obtain it, as well as other resources, are available at *http://fvs.aicpa.org*.

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$671,000, whereas the second court would have awarded only $285,000—a significant difference to say the least.

A consequence of these two competing methods is that comparability between the two approaches is inherently complex. By using the discount rates accepted in each case, it would be necessary to reduce the income stream in the first matter by almost 60% to achieve results comparable with the second matter, i.e., a $42,000 income stream for 10 years discounted at 8%.

Although at this time the courts have offered limited guidance related to appropriate discount rates or methods to determine them, the CPA analyst continues to be in a good position to make these judgments. A follow up article in *The Witness Chair* will address the cases that currently provide guidance related to the determination of discount rates. Also, the AICPA is developing a practice aid related to discount rates, which should be available by year end.

In addition to the Dunn and Harry article, we recommend the following additional resources on this topic:

- Dunn, Robert, L., *Recovery of Damages for Lost Profits*, 6th Edition, Lawpress Corporation, 2005 (with March 2008 Supplement).
- AICPA Practice Aid 06-04, *Calculating Lost Profits*.

For those interested in a more in-depth discussion, we also recommend listening to or reading the telephone conference transcript of the Business Valuation Resources, LLC July 20, 2005 Telephone Conference *Discounting Damages to Present Value: Today's Hottest Issue*.

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Greg Regan, MBA, CPA, CFE *is Economic Damages Section secretary and a director in the litigation and forensic consulting practice of Hemming Morse, Inc. in San Francisco.*

HAPPENINGS

LITIGATION SECTIONS MEETINGS

Business Valuation	Thurs., Nov. 20	SFO
	Thurs., Jan. 29, 2009	LAX
Economic Damages	Wed., Nov. 12	SAC
	Wed., Feb. 4, 2009	LAX
Family Law	Fri., Nov. 21	SFO
	Fri., Jan. 30, 2009	LAX
Fraud	Wed. Nov. 12	SAC
	Tues., Feb. 3, 2009	LAX

Each section sends individual meeting notices.
Download a registration form at *www.calcpa.org/LIT*
or contact Barby Petersson at (818) 546-3502

EDUCATION FOUNDATION OFFERINGS

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

2008 ABV Exam Review Course	Wed–Fri., Oct. 1-3	LA/BH
Audit Standards Update: The New Audit Risk Assessment Standards	Wed., Sept. 3	BUR
	Mon., Nov. 3	SAC
	Wed., Dec. 3	Palm Springs
	Mon., Jan. 5, 2009	LAX
Business Valuation Overview	Wed., Nov. 5	OC South
Business Valuation: A Review of the Essentials	Wed., Dec. 10	SAC
Family Law Conference	Thurs., Oct. 23	SF
	Fri., Oct. 24	LAX
Guiding Clients Through Divorce	Mon., Sept. 8	Fresno
Litigation Staff Workshop: The Basics All Practitioners Need to Know	Thurs., Oct. 2	SF
Tax Issues in Divorce	Tues., Oct. 28	SLO
	Mon., Nov. 10	SF

Litigation Sections BV Practice Aid

Earlier this year, CalCPA's Litigation Sections issued the Practice Aid Checklist on the AICPA's *Statement on Standards for Valuation Services No. 1* (SSVS No. 1). Developed by BV Section members, the practice aid is not an interpretation of SSVS No. 1, but rather a tool to help guide members implement and comply with the standards.

SSVS No. 1 is effective for engagements accepted on or after Jan. 1, 2008. Because the California Board of Accountancy Regulations Sec. 58 state that CPAs must comply with all applicable standards, SSVS No. 1 applies to all California CPAs who perform valuations, regardless of their AICPA membership status.

Download the practice aid at http://www.calcpa.org/Content/yoursociety/lit.aspx.

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