Financial Valuation *and* Litigation Expert

VIEWS AND TOOLS FROM LEADING EXPERTS ON VALUATION, FORENSIC/FRAUD AND LITIGATION SERVICES

Editor's Outlook

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Before you read any further, take a look at pages 38-40 of this "new concept" publication. Listed here is our "Panel of Experts." I am proud to say that this esteemed group includes many of the leading experts in financial valuation, forensics/fraud and litigation services. These national experts are the strength of this bimonthly journal and our source for insightful and concise columns.

That's another theme here—columns from an incredible knowledge base that are short and to the point. Most of the columns are one page, with some at two to three. No, you won't be sold short. We have presented columns that are mostly intermediate and advanced, with some that are more basic.

However, some are not as basic as they seem. For example, the column by Mel Abraham presents what first appears to be a very basic concept, that of a hypothetical buyer/seller in valuation. When I first started to read Mel's article I thought, "Now wait a minute, I know this concept inside out." When I finished Mel's article I thought, "Wow, that 'bright line' separating a hypothetical buyer/seller under fair market value from transaction attributes more specific to investment value is not that bright and, if not thought through, can result in the

Continued on page two

Litigation Services and Fees: What Clients Need to Know

Financial experts are often retained by clients or clients' attorneys in a dispute to prepare financial analyses, e.g., lost profits or a valuation. The attorneys usually have a very good idea how expensive lawsuits can be to their clients. However, many clients, while understanding why their attorneys' fees are so high, do not understand why the financial experts' fees may be high as well. We're not talking about hourly rates here but more the number of hours financial experts put into preparing and defending their work, conclusions and opinions. So, why are experts' fees so high?

They're high because a good financial expert is detail-minded and knows that he or she must have good command of the facts and procedures in an engagement. Why is there a need for such detailed knowledge? Because some attorneys will try to make a financial expert look biased, unprepared or unqualified, even though he or she is not. Experienced experts know and anticipate this. They understand that attorneys are advocates whose job is to convince a trier-of-fact that an expert is wrong, even when the expert knows, and often the opposing counsel knows, the expert is right. The judicial system for attorneys is an advocacy system, and financial experts who work in litigation services understand and respect this.

So what do clients need to know? They need to know that it takes time and fees to enable experts to withstand such potentially misdirected cross examination. This is why the amount of hours required and the related fees are so much higher in dispute work than other types of work. While always acting as independent and objective experts, they must also

Continued on page three

EXPERTS in this ISSUE . . .

Financial Valuation *and* Litigation Expert

Publisher	Valuation Products & Services, LC
Editor in Chief	**James R. Hitchner, CPA/ABV, ASA** The Financial Valuation Group The Financial Consulting Group
Executive Editor	**Michael J. Mard, CPA/ABV, ASA** The Financial Valuation Group The Financial Consulting Group
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HITCHNER, continued

right value for the wrong asset."

Mike Crain presents an insightful article distinguishing between the valuation of intellectual property and the determination of lost profits. Tom Hilton talks about choosing the correct damage period, a foundation in damage calculation, and Michael Kaplan questions why attorneys and their clients don't use financial experts more often in mediation to settle cases. Jim Alerding and Steve Hyden present their views on using "guideline" royalty rates for damage calculations and valuation.

Mike Hill Jr. is the first columnist in our "What's Going On At…" column, which will highlight one valuation, fraud/forensics or litigation group or association. Mike is chair of the ASA BV Committee and presents some important things going on there. Bob Grossman, whose column in this issue deals with the relationship of control premiums and lack of control discounts, will be featured in our next issue as the incoming chair of NACVA's Executive Advisory Board.

In our industry corner, we highlight some important trends in healthcare from Mark Dietrich and software businesses from Jim Rigby. Eva Lang presents a new tool, Fetch XL, for obtaining public company data and valuation multiples. Larry Cook presents collaborative divorce issues.

We also have a column on the guideline public company method from Bruce Bingham. He shares his ideas on how to present this complex method in a way that makes sense. Nancy Fannon takes on the topic of transaction databases, offering important caveats on their proper use. Rod Burkert presents some controversial ideas on normalization adjustments. That is another goal of this publication— to present ideas for discussion and comment. Thanks, Rod, for throwing your hat, or is it neck, into the arena. We can't grow as a profession without those brave souls who have the courage to question that which is generally accepted.

Ron Seigneur presents a synopsis (to be expanded) on the use of Duff & Phelps risk premium data, something we as analysts can no longer ignore. Did you think FLP discounts are straightforward? Read John Stockdale's column on closed-end fund data and learn what his investigation found. Mike Mard, in the company analysis column, presents the new concept of Strategic Benchmarking For Value (SBV), which allows analysts and business owners to better understand what drives value. I want to give a special thanks to John Stockdale, Jr. and John Gilbert for contributing court case summaries and Steve Babitsky, Esq., for his deposition checklist.

Two last things before you read on. I want to thank my partner in this venture, Mike Mard, as well as our managing editor, Karen Warner and our business manager, Deanna Muraki. I also want to mention that this premiere issue is more of a double issue. Future issues will be between 20 and 40 pages. Thank you.

defend what they believe to be their correct opinion or conclusion, regardless of how opposing counsel tries to obfuscate their opinions. To do a good job, experts have to anticipate attacks on their work that are not always fair to them. Of course, experts should never be advocates for their client's position. However, they can and should be advocates of their own independent and objective opinions and must take the necessary steps to properly defend their work.

Furthermore, financial experts need to keep up in their industry, which is in constant change. Also, anything they have written in the past may be used by an attorney in an attempt to discredit an expert. This all takes preparation, which takes time and often causes higher fees.

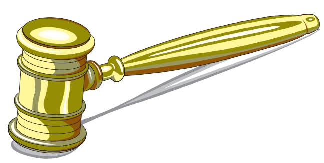
Let's take an example. To properly apply the guideline public company method of the market approach in a valuation takes time. An attorney can pick one guideline company, and from a 100- page SEC filing, pick any piece of information and ask first, whether the expert is aware of it, and second, how that piece of information was specifically considered. Well, if the information is relevant and the expert doesn't have a good reply, his or her credibility may suffer even though that piece of information may have no real impact, by itself, on the value conclusion. A well prepared expert will be ready to respond, possibly after reviewing the relevant documents, that he or she knew about it and will be able to explain how he or she considered it, or alternatively, explain why it is not material.

So, for all you current and potential clients out there, remember that anticipation of an appropriate defense of an expert's work is the reason fees for litigation-related work are often so much higher than non-litigation work. Computing the value or economic damages related to a company can be hard; defending such work is even harder and is really where the rubber hits the road.

Let's get back to not appearing biased, unprepared and unqualified. James Babitsky, along with James Mangraviti, both of SEAK, Inc., have published two books on cross examination.[1] Mr. Babitsky is a member of our Panel of Experts and has allowed *FVLE* to use the following questions and potential replies, with modifications as appropriate, of the type of questions some attorneys may ask to discredit an expert.

Note that many of the questions are meant to unsettle the expert and have only limited, if any, real relevance to the financial analysis. As such, financial experts must know the detailed as well as more generic attempts to discredit them.

This article attempts to help clients to understand the environment in which financial experts work in defending their opinions, and again, why litigation services can and often will be expensive.



[Editor's Note: These testimony excerpts are meant to be illustrative and educational with a humorous twist. We'll leave it up to you to decide which answer, if any, is the best. The questions and replies are from SEAK or modified based on SEAK, and are not the replies the publishers, editors or authors would take in a specific situation. Below are some exchanges between a valuation analyst/appraiser, Val Dude, and a cross examining attorney, Troy T. Getcha. We hope you enjoy the humorous aspects of this as well. Remember though, real life is often funnier than fiction.]

Question: Mr. Dude, does the business valuation that you have prepared here incorporate the latest methods, approaches, and information available to business valuators?
Answer: Yes... I, I, I think so.

Question: Tell me exactly how many new concepts, ideas, methods, information, etc. that you have applied.
Answer: I'm not sure I can answer that.

Question: Is it fair to say, then, that you have no idea whether your business valuation and the conclusions that you have presented to this Court have been prepared using current ideas, methods and information?
Answer: Yes.

Question: You previously said that you appraise companies in many industries, correct?
Answer: Yes.

Question: Have you appraised companies in, say, more than 50 industries?
Answer: Probably.

Question: That's a lot of industries, correct?
Answer: Yes, it is, but that's over a long career.

Question: Let me ask you this. Have you ever heard of the saying that begins "Jack-of-all-trades?"
Answer: Yes.

Question: Do you know how that saying finishes?
Answer: Yes.

Question: How does it finish?
Answer: "Master of none."

Question: Mr. Dude, do you feel that it's important to know the history and nature of the company as well as the industry in which it operates?
Answer: Yes.

Question: In fact, isn't that contained in Revenue Ruling 59-60, which you have testified you have relied upon?
Answer: Yes.

Question: Are customers important to the company?
Answer: Yes.

Continued on page 34

[1] Steven Babitsky, Esq. and James J. Mangraviti, Jr., Esq., SEAK, Inc. *How to Become a Dangerous Expert Witness*, 2005 and *Cross-Examination: The Comprehensive Guide for Experts*, 2003. Used with permission.

Can a Hypothetical Buyer/Seller be Too Hypothetical?

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Certain basic questions should be asked in a tax valuation, including:

- "What really needs to be valued?"
- "What asset is the hypothetical buyer and seller transacting?"
- "What investor attributes, if any, should be considered without violating the hypothetical buyer-seller concept?"

The answers to these basic questions help insure that the analyst is providing what the client needs and that he or she is valuing the proper assets and attributes. I have seen many valuation analysts, as well as other professional advisors, fail to ask some of these very basic questions.

I recently helped to resolve a case with the IRS in which the most important element was documenting and describing what opportunities, risks, limitations and obligations were, in reality, being transferred.

The situation was complex, but in a simplified form, there was an operating business that was being run by two sons of the decedent. The operating assets, including the real estate, were held in a separate partnership and leased back to the business. There were no written leases between the two entities. The ownership was such that the decedent and her daughter held the majority of the operating business, and the brothers held the majority of the partnership. However, the sons were actually operating the business.

For the four years prior to the decedent's death, the sons were estranged from the mother and the daughter. Upon the decedent's death, the daughter took over the interests of the mother and ultimately fired the sons. Litigation ensued, whereby the judge allowed the daughter to take the operating entity and the sons to take the partnership.

Since there were no leases, the sons ultimately evicted the business and also were able to compete directly with the business since they had access to the assets and the relationships with the customers. This business was a capital-intensive business with unique equipment requirements. The inventory alone was millions of tons of raw material, and the equipment had to be specially installed, thereby making it difficult to simply move to another location without substantial costs and downtime.

Given this set of circumstances, it was important to accurately and substantially document the true economics of the interest being transferred to the hypothetical buyer under the estate tax provisions. To simply assume "business as usual" (which is what the IRS valuation analyst did) would have been erroneous and would have over-valued the asset. The ultimate resolution in this matter was that our value, based upon our work in documenting these specific factors, was effectively upheld (within $100,000 of our value whereas almost $3.5 million reduction off the IRS analyst's value).

Per my example, defining the asset in order to fully assess the risks, returns, and their respective stability or instability is an important step in the valuation process. It is often ignored or disregarded under the hypothetical buyer/seller definition for tax purposes. An analyst's function is, in reality, a monetary quantification of the specific rights associated with a specific ownership interest. An investor is investing in a specific bundle of rights. It is the characteristics of value of these rights that impact the value of an investment and provide some indication as to the risk and return as well as possible control that can be derived from the investment.

Consequently, if the analyst does not properly define the rights associated with a specific interest to be valued, the resulting value (although in and of itself may still be correct) may be of the wrong asset. Obviously, everything else being equal, the more rights associated with a specific investment or interest, the more valuable it may be to an investor.

The question of "What is being valued?" becomes critical at the outset of an engagement. Although this question seems basic and obvious, the answers may not be. It demonstrates the importance of working as a team to produce the appropriate result for the client. Legal counsel, the client, and the client's CPA were instrumental in providing us a thorough understanding of the unique characteristics in this matter.

expert TIP

The assumption of a hypothetical buyer and seller may not always mean rejection of transaction-specific factors affecting the rights and risks in owning an asset.

The Pratt's Stats Private Transaction Database: Items you need to know

This article is adapted in part from CCH Incorporated, Business Valuation Alert, Sept. 2003, "The Direct Market Data Method: Common Errors in Application and a Closer Look at the Transaction Databases," by Nancy J. Fannon and Heidi P. Walker, copyright 2003, Nancy J. Fannon.

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Pratt's Stats Private Transaction Database is an excellent resource for finding transactions. It gathers data from business intermediaries and SEC filings and contains over 8,200 transactions from 1990 to the present, with deal prices ranging from less than $1 million to $5.9 billion. There are up to 80 data points for each transaction. Pratt's Stats provides a great deal of information on how to use its data in the Frequently Asked Questions (FAQ) section of its website. Furthermore, the staff at Pratt's Stats can be very helpful in answering questions. In this article, we highlight a few critical points about the database and how to use it. It is our responsibility to be sure we understand how to properly use the data upon which we rely.

Read the Transaction Reports

Pratt's Stats generally covers deals that, due to their size and the amount of information available for each, can be analyzed on a transaction-by-transaction basis. Therefore, important information in the Transaction Reports should not be ignored.

In the example in Table A, the Transaction Report noted: "Consideration paid as follows: $17,138,000 cash, $2.7 million promissory note for real estate…" The footnote to the MVIC price says the deal did not include real estate, as is noted in every Pratt's Stats deal. As such, the $2.7 million for real estate must be removed from the price.

Additional notes indicated that "EBT includes stockholder bonuses expense of $3,449,000 and other income of $101,824." Table A demonstrates the difference between the unadjusted and adjusted multiple and highlights the importance of analysts calculating their own multiples when they can, particularly when using the guideline company transactions method as a primary method.

TABLE A
READING THE TRANSACTION REPORT

	UNADJUSTED	ADJUSTED
MVIC Price	$19,838,000	$17,138,000
EBITDA	$996,679	$4,343,855
MVIC/EBITDA	19.9	3.9

Equity Price Versus Market Value of Invested Capital (MVIC)

We believe the application of Pratt's Stats "Equity" and "MVIC" multiples to be widely misunderstood. In many transactions, "Equity Price" and "MVIC" are the same. Often though, the seller's EBIT and EBT are different, indicating that the seller carried interest-bearing debt. Let's look at an example (Table B):

TABLE B - SAMPLE TRANSACTION REPORT

Interest Expense	$119,000
Equity Price	$5,600,000
MVIC	$5,600,000
Liabilities Assumed	N/A
EBITDA (calculated)	$613,000
EBT	$435,000
Equity Price/EBT	12.87
MVIC/EBITDA	9.13

Note that Equity Price and MVIC are the same and Liabilities Assumed is "N/A," an indication that the buyer did not assume debt. According to the FAQ, "if the Liabilities Assumed field is left blank, it can be assumed that the purchaser did not assume any of the seller's long-term financing liabilities, or that the amount of the long-term financing liabilities assumed was immaterial relative to the consideration paid." Given $119,000 of interest expense, we will assume that the seller had debt of approximately $2.0 million ($119,000 divided by 6 percent assumed rate of interest).

Continued on page six

MVIC/EBITDA is calculated as price (which does not include the assumption of debt) divided by EBITDA. In the case of equity price/EBT, we use the same price, which again does not include the assumption of debt, divided by EBT, which is after the deduction for interest expense— somewhat of a mismatch from our typical thinking.

Let's see what happens when the multiples are used in the typical manner to calculate equity value. Assume that the subject company virtually mirrors the seller, with identical EBT and EBITDA, and debt of $2.0 million (Table C).

TABLE C - RESULT USING MULTIPLES AS TYPICALLY APPLIED

	Equity Price/EBT	MVIC/EBITDA
Multiple	12.87	9.13
Subject Company EBT	$435,000	
Subject Company EBITDA		$613,000
Value Indication	$5,600,000	$5,600,000
Less: Interest-bearing Debt	?	$2,000,000
Value of Equity	$5,600,000	$3,600,000

What should we do with the debt? As the calculation shows, if the analyst were to use the equity multiple without deducting debt, he or she would overstate the value of the company. This is because the denominator (EBT) includes a deduction for interest expense on debt that the buyer does not assume. Thus, when using the multiple, the resulting value needs to be reduced by the interest-bearing debt.

While we do not typically think of deducting debt when using equity multiples, if no liabilities were assumed and the company you are valuing has debt, you must subtract debt to arrive at the value of the equity. To avoid this issue, we tend to use only the MVIC multiples.

Distinguish Between Asset Sales and Stock Sales

Asset sales and stock sales should be analyzed separately, as different assets and liabilities of the subject must be added or subtracted from the value indication to arrive at the value of equity. Pratt's Stats FAQ states that in a stock sale, the entire legal entity of the company transfers, including all assets and liabilities, unless otherwise specified in the purchase agreement.

With regard to asset sales, the database assumes that all, or substantially all, operating assets are transferred. Generally, but not always, the following are not transferred in an asset sale: cash, trade receivables, prepaid expenses, real estate, and non-operating assets.

***expert* TIP**

Pratt's Stats provides us with a great deal of transaction data and instructions on proper use. However, it is our responsibility to be sure we understand how to properly use the data upon which we rely.

Does the Sum of the Parts Equal the Whole?

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The proper application of control premiums and discounts for lack of control requires an understanding of the relationship between the two. Equally important is how they correspond to a business entity's total equity value (assumed in this article to be 100 percent control value) using the fair market value standard.

Under fair market value, a basic premise of business valuation is that the value of all fractional interests may not add up to total equity value. This is certainly the case, and rarely disputed, where a company's common equity is divided among five 20 percent ownership interests. In the simplest case, each of the five 20 percent interests would be valued the same. Each would constitute a non-controlling interest. The sum of five non-controlling interests, valued separately, do not add up to the 100 percent total equity control value.

It is less clear to many users of business valuation reports when the total equity value is comprised of at least one controlling interest within the company's common equity structure. Assume as an example a common equity structure of a single 55 percent controlling interest and three 15 percent non-controlling interests. Users of business valuation reports may think that the sum of these four separate common equity interests should equal total equity value. Such a conclusion requires that the 55 percent interest would, in effect, include a "premium" for control equivalent to the total discounts accorded the three 15 percent interests for the lack of control inherent in each. Often, the very same arguments that are presented as substantiation for validating discounts for lack of control are applied in the opposite direction as merit for control premiums.

A basic example illustrates the flaw in this interpretation. Assuming a $5,000,000 total equity value, the 55 percent interest would be worth $2,750,000. As the base level of value is presumed to be controlling, no further premium is generally required for the control attribute.

If we assume that each of the three 15 percent interests are worth $750,000 on a controlling interest basis, it is necessary to apply a discount for lack of control to "convert" the value from controlling to non-controlling. For illustrative purposes, assume a discount for lack of control at 30 percent, which results in a value of each non-controlling 15 percent interest of $525,000.

The sum of the value of the 55 percent interest and the three 15 percent interests is then $4,325,000. This total is $675,000 or 13.5 percent lower than the assumed total equity value.

If, as critics argue, the $675,000 difference is added to the value of the 55 percent interest so that the total value for all interests then equals $5,000,000, an additional 24.5 percent control premium is required to be applied to a value that is already deemed to be on a controlling interest basis. Moreover, the total percentage control premium, had the 55 percent interest been valued originally on a non-control value, assuming again a 30 percent discount for lack of control, is a whopping 78 percent!

The dynamics of any buyer, financial or otherwise, purchasing a control feature at a 78 percent premium is unlikely. Evidence of live transactions and the levels of acquisition/control premiums (e.g., Mergerstat) suggest significantly lower premiums. Adding additional weight to counter arguments is the deemed sale price value of the 55 percent interest. Whether a buyer of an equity interest is willing to pay a premium beyond his or her portion of any sale proceeds due is always case- and fact-specific. In the instant case, the buyer would receive no more than $2,750,000 if the 55 percent interest were later sold for the $5,000,000 total equity value. Presumably, this would be a major factor in his or her purchase decision.

The issues addressed herein are even more egregious in capital structures where only one to two percent of total equity constitutes all of the controlling interests of the entity, e.g., family limited partnerships. Such cases would require "super premiums" be added to controlling interests to attain the result of all fractional interest values equaling total value. Such super premiums are non-sensical and invalidate the premise that the sum of the parts always equals the whole.

expert TIP

The discount for lack of control applied to non-controlling equity interests will usually not correspond to a premium for control applied to a controlling interest in the same company.

Editor's Note: This article does not endorse the blind application of acquisition/control premiums using public company acquisition data (e.g., Mergerstat), which will be a topic in a future issue of FVLE.

CONTROL ADJUSTMENTS AND LEVELS OF VALUE: Reality or Make-Believe?

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The assignment: Determine the fair market value of a minority interest in a private company.

Your initial investigation tells you the company is fairly large but does not have reliable financial projections. To apply the guideline public company and capitalization of cash flow valuation methods, you will need to adjust the historical income statements.

You have spread the historical financials and are now prepared to adjust the income statements. The end result of these adjustments should yield the hypothetically transferable earnings (to be later converted into cash flows) that is consistent with the standard of value being applied and the size of the interest being valued. The problem is that there are differences of opinion regarding which kind of adjustments are appropriate when valuing a minority interest.

Most analysts have little difficulty identifying and making the "easy" normalization adjustments. Such adjustments remove the effects of unusual, non-recurring items and the income and expense associated with non-operating assets and liabilities. Rarely is there any debate about the propriety of these adjustments, although I have heard spirited discussion about eliminating items relating to non-operating assets and liabilities when valuing a minority interest.

The real controversy involves adjustments that normalize officer and owner salaries and remove other discretionary expenses that would usually not exist in a public company. Some analysts do not make these adjustments when valuing a minority interest because they point out that the interest lacks the power to make such changes to the earnings stream; these analysts argue that these adjustments are "control" adjustments. This position may not be defensible, as can be seen from the following connected threads.[1]

1) Minority shareholders in public companies also lack control over officer salaries and discretionary expenses. But, they expect normalized operations, and generally, they get it.

2) Using inadequately adjusted earnings implies, vis-à-vis a capitalization model or terminal value calculation, that the minority shareholder will be disenfranchised into perpetuity and will never receive his/her pro rata value even if/when the company is sold.

3) Discount rates based on Ibbotson data and market multiples obtained from guideline public companies are derived from such completely normalized earnings and, therefore, should be applied to private company earnings that are an "as-if public equivalent."

4) The combination of #1, #2, and #3 puts you at the "minority, marketable" level of value. If you start with adjusted earnings that are less robust, you are at some make-believe level of value– call it the "being taken advantage of minority, marketable" level of value.

5) DLOMs based on restricted stock and pre-IPO studies are deducted from the minority, marketable level of value, not a "being taken advantage of" level of value.

6) And finally, couldn't a rational hypothetical investor sue under a state's shareholder rights statutes if it was being permanently deprived of its pro rata value because of egregious officer salaries and discretionary expenses?

Thus, suboptimal earnings are transitory in the real world– the world that is being mirrored by the fair market value standard. Normalizing officer salaries and discretionary expenses correctly reflects the fact that these items do not affect the value of the enterprise at the minority, marketable level of value. If you need to consider the impairment of value that officer salaries and discretionary expenses have on the value of the minority interest, then consider it in your determination of the appropriate DLOM.

It is often said that valuation is as much of an art as it is a science; however, there is no room for make-believe. If you do not make adjustments to normalize officer salaries and remove discretionary expenses, your conclusion may not be at a minority, non-marketable level of value. The result may be at some other unsupportable level of value.

[1] Chris Mercer was the first to raise this issue and argue these points. See Mercer Capital *Value Matters,*™ Volume 2004-06, September 24, 2004. For a contrary view, see Samuel Y. Wessinger, "Public Equivalent Value: Are Earnings Adjustments Required in Minority Interest Valuations?" *Valuation Strategies*, July/Aug. 2005, 14-21.

Editor's Note: This article is controversial and is opposite many analysts' views. I applaud Mr. Burkert for posturing this position for discussion, and I welcome readers' comments, whether in agreement or not, in future "Letters to the Editor" columns.

expert TIP

There is an alternate view as to appropriate levels of value and the justification for making control adjustments to determine a minority interest value.

Family Limited Partnerships: Understanding Discounts from General Equity Closed-End Funds

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The observed discount between market value and net asset value of closed-end funds is a valuable tool in the valuation of holding companies. This article presents a number of observations about general equity closed-end funds that will be useful when analyzing the observed discounts in order to apply them in the valuation of a holding company. This discount has been an issue in several tax court cases that have discussed how best to determine and use these observed discounts in valuations of family limited partnerships.

The general equity category is used for analysis because this category includes closed-end funds that invest primarily in U.S. equities using various strategies and objectives. The discounts discussed below were computed using data as of March 17, 2006. The *Wall Street Journal* listed 68 funds in the general equity category on that day.

These funds show very substantial variability in the size of the discount. It was an average of about 5 percent but varied from a premium of 45 percent to a discount of -21 percent. A good portion of this variability is explained by segregation of these funds into the following six groups:

1) Funds that do not regularly report underlying asset data and are not useful in determining a discount. There are five funds in this group.

2) One fund that holds the majority of its investment in one publicly traded stock and of limited usefulness in determining a general discount for many FLPs.

3) Funds that hold investments in private companies. There are two funds in this category, and they tend to show a large discount to the stated value of the underlying holdings. However, the values of the private companies held are not reported on a weekly basis.

4) Funds that hold investments in U.S. equities and do not have a policy stating distribution as a percent of net asset value nor use options heavily. Generally, these are funds that have been in existence for a relatively long time. All of these funds traded at a discount, and the average discount for the 24 funds in this group was approximately 12 percent.

5) Funds that use options heavily as a matter of policy. Most of these funds are relatively new and state an intention to emphasize the generation of income over capital gain. There are 21 funds in this category. The average discount for these funds was approximately 4 percent.

6) Funds that have a managed dividend policy indicating the payment of a dividend that is a specific percent of net asset value. These funds tend to be older funds that revised their dividend policy in recent years. SEC approval is needed to adopt this dividend policy, and such policy has apparently not been granted by the SEC recently. There are 14 funds in this category. Most of these funds traded at a premium, but some traded at a discount of less than 10 percent. On average they showed a premium of about 5 percent.

The difference in the average discount or premium for the latter three groups can be shown to be statistically significant using an analysis of variance technique. However, there is significant variability of the discount within each group. Statistical analyses have been conducted using various factors that might have a relationship to the size of the discount within the group that could be used to explain this variability.

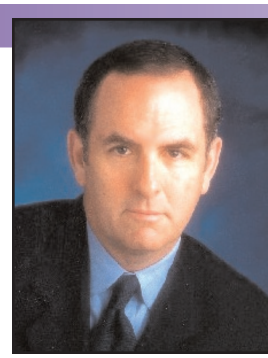
The relationships change over time. While some of them had statistical significance at various points in time, the statistical relationships were weak; that is, they had relatively low coefficients of determination.

Surprisingly, this shows that additional quantitative factors, such as fund size and historical rate of return, are not useful in explaining the variation of the discount within a group. This leads to the conclusion that a median or mean from the group of funds similar to a subject entity being valued may provide a good starting point for determining the discount to apply.

expert TIP

A median or mean from the group of funds similar to a subject entity being valued may provide a good starting point for determining the discount to apply.

Relief from Royalty Method



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Depending on the industry, the value of intangible assets typically accounts for a vast majority of an enterprise's total value. Identification of intangible assets is as broad as the mind is creative. There are familiar intangibles such as customer base, in-process research and development, and technology, as well as intellectual property, such as patents, copyrights, trademarks, trade secrets, and know-how. There are also intangible assets peculiar to an industry or enterprise, such as bank deposits.

Managing a company's intellectual property requires understanding value for sale/purchase transactions, licensing in or out, patent infringement litigation, strategic planning, or bankruptcy proceedings. Each of these valuation purposes depends on several critical variables, which may include:

- The appropriate standard (definition) or value that should be used (e.g., investment/strategic value, fair market value or fair value)
- The appropriate premise of value that distinguishes going-concern value or liquidation value
- The projected economic benefit stream
- Remaining economic life
- The appropriate discount rate
- The appropriate royalty rate
- Any adjustments required by case law or supported by market research

This article focuses on brand valuation, and in particular, the income approach/relief from royalty method. Reasons for valuing brands may include:

- Tax compliance (transfer pricing, estate/gift)
- Financial reporting (fair value measurement, SFAS 141, SFAS 142)
- Litigation (shareholder disputes, divorce, bankruptcy, damages)
- Corporate planning (acquisition, divestiture, financing, on/off balance sheet, joint venture, licensing, sale/lease back, securitization)

To value a brand, the cost approach and market approach are generally not used. It is often difficult to accurately identify all the costs related to recreating the brand and building recognition, a factor used in the cost approach. Trademarks, trade names and brands rarely sell in the marketplace, and the information required to perform a direct comparative asset market approach is rarely available.

One of the most comprehensive methods to value the brand is a variant of the income approach known as the relief from royalty method. The relief from royalty method equates the value of a trademark, trade name, or brand to the portion of the company's earnings that represents the pretax royalty that may have been paid for using the brand as if the company did not own the brand.

Three stages of the relief from royalty method:

1) **Choosing the royalty rate proxy:** The pretax royalty rate is selected based on observed royalty rates in the market and on an analysis of the rate that a company's margins could support. In this example, we observed market data in The Financial Valuation Group's proprietary database (www.fvginternational.com) documenting the median average range of royalty rates for brands as of a certain period to be 2.75 percent to 11.00 percent (Exhibit 1). Based on these observable transactions and the available profitability of the hypothetical licensee (including using the 25% rule; more on that in the next issue), we deemed a 4 percent royalty was appropriate.

2) **Forecast period:** The rights to use the brand name transfer to the buyer in perpetuity, giving it an indefinite life. The fair value of the brand name is the present value of the royalties projected here for a 10-year period, plus the present value of the residual at the end of the 10-year period, plus the amortization benefit (see Ex. 2, p. 11).

3) **Discount rate:** A 16 percent rate of return was chosen in this example to reflect a risk assessment that the brand name was about as risky as the business overall; i.e., the weighted average cost of capital. Exhibit 3 (p. 11) shows the final analysis of the value of the brand name. ∞

EXHIBIT 1 - ROYALTY RATES

TYPE	MEAN	MEDIAN	LOW	HIGH
Decorative, Art, Character	13.84%	11.00%	0.05%	50.00%
Games and Toys	10.15%	9.25%	1.00%	38.00%
Parts, Systems, Instruments	3.19%	3.50%	0.30%	5.00%
Fashions and Accessories	6.16%	5.50%	0.75%	16.00%
Toiletries	4.31%	5.00%	1.50%	7.00%
Sports	6.18%	5.00%	1.00%	20.00%
Graphics	9.22%	5.00%	2.00%	60.00%
Food Products, Drinks	4.98%	6.00%	0.80%	11.00%
Hotel, Real Estate	2.51%	2.75%	0.36%	4.00%

Exhibit 2 - Amoritization Benefits[1]

The formula for the amortization benefit is:

AB = PVCF*(n/(n-((PV(Dr,n,-1)*(1+Dr)^0.5)*T))-1)

Where:

AB	**=**	**Amortization benefit**
PVCF	**=**	**Present value of cash flows from the asset**
n	**=**	**15-year amortization period**
Dr	**=**	**Discount rate**
PV(Dr,n,-1)*(1+Dr)^0.5	**=**	**Present value of an annuity of $1 over 15 years, at the discount rate**
T	**=**	**Tax rate**

[1] Michael J. Mard, James R. Hitchner, Steven D. Hyden, Mark L. Zyla. *Valuation for Financial Reporting: Intangible Assets, Goodwill, and Impairment Analysis, SFAS 141 & 142* (New York: John Wiley & Sons, Inc., 2002).

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The relief from royalty method is one of the most often used methods to value trade names, trade-marks and brands.

Exhibit 3 - Sample Company - Income Approach - Relief from Royalty Method

VALUATION OF BRAND
AS OF DECEMBER 31, YEAR 1
($ 000s)

Note: Five years shown for demonstrative purposes.

		FORECAST YEAR 1	2	3	4	5
Net Revenues Under Brand (Total Company)		$72,000	$86,400	$99,360	$109,296	$120,226
Pretax Relief from Royalty	4.0%	$2,880	$3,456	$3,974	$4,372	$4,809
Income Tax Liability	40.0%	1,152	1,382	1,590	1,749	1,924
After-tax Royalty		$1,728	$2,074	$2,385	$2,623	$2,885
Present Value Income Factor	16.0%	0.9285	0.8004	0.6900	0.5948	0.5128
Present Value Relief from Royalty		$1,604	$1,660	$1,645	$1,560	$1,480
Sum of Present Value Relief from Royalty, Years 1-10			$13,872			
Residual Calculation:						
Year 10 After-tax Royalty		$4,142				
Year 11 After-tax Royalty, Assuming Growth of	5.0%	$4,349				
Residual Capitalization Rate		11.0%				
Residual Value, Year 11		$39,537				
Present Value Factor		0.2441				
Fair Value of Residual			9,653			
Fair Value of Brand			23,525			
Amortization Benefit						
Discount Rate	16.0%					
Tax Rate	40.0%					
Tax Amortization Period	15					
Amortization Benefit			4,485			
Fair Value of Brand			$28,010			

Note: Some numbers may not foot due to rounding.

Driving Your Company's Value: Strategic Benchmarking for Value

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What is the magic formula for increasing a company's value? Well, there is no magic formula, but this article will discuss a revolutionary, structured process called Strategic Benchmarking for Value (SBV) that will help business owners and management solve this dilemma. SBV is a process that helps companies to increase value by balancing strategy, systems and people using performance measures enhanced for private companies. This enhanced, balanced scorecard is a structured framework for management to identify, manage and monitor the company's critical success factors. This includes a few key areas where "things must go right" for the business to flourish and for its strategy to be achieved.

To fully understand SBV, we start with a typical employee's understanding of a business.

Exhibit 1 shows that people generally understand that a business takes money, people, buildings and other equipment and intangibles, mixes them up and hopefully produces something customers want and will pay for. With luck, after paying for all these things, there will be money left over for the investors.

An MBA's view might be presented as Exhibit 2, which shows financial capital (money), human capital (people), physical capital (buildings and equipment), and organizational capital (intangibles) working through systems capital (mixing bowl) to produce satisfied customers resulting in customer capital and return to investors.

Now turn Exhibit 2 counter-clockwise 90 degrees and you have Exhibit 3 (p. 13) , the SBV Framework. This exhibit takes the four inputs of financial, organizational, human and physical capital, enables them through systems, and results in outcomes that appeal to customers by focusing on product or service attributes, customer relationships or company image. The result of this exercise is measured monthly via the company's return on equity and free cash flow.

The SBV Network calls the relationship between return on equity (ROE) and free cash flow (FCF) the Return on Strategic Effectiveness (ROSE), which is an analysis that tells us whether the company's value is going up or down and why. It is based on key performance metrics at the enterprise level.

The SBV Process does not focus on the amount of return on equity, but on the direction of movement. As long as ROE is improving and free cash flow is growing, value will be improving.

The SBV process is five steps:[1]

1. Define the current state
2. Define the desired future state
3. Establish strategic benchmarking keys
4. Execute effective alignment for strategy, systems and people
5. Benchmark and monitor the ROSE

This process culminates in value growth, as shown in Ex. 4 (p. 13). ꧁

[1] For more information on the SBV model and tools, visit www.StrategicBenchmarking.com, or see Michael J. Mard, Robert R. Dunne, Edi Osborne, and James S. Rigby, *Driving Your Company's Value: Strategic Benchmarking for Value, John* Wiley & Sons, Inc., 2005.

Exhibit 1 - Typical Employee's View of a Business

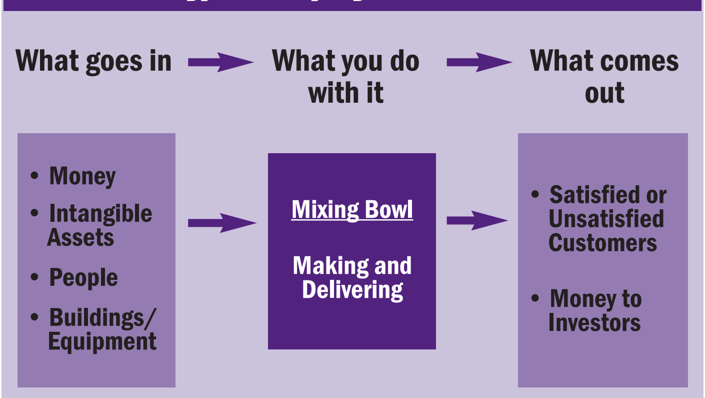


Exhibit 2 - An MBA's View of a Business

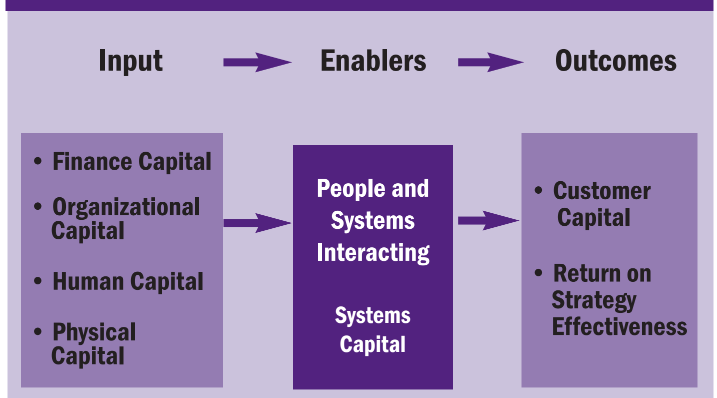


Exhibit 3

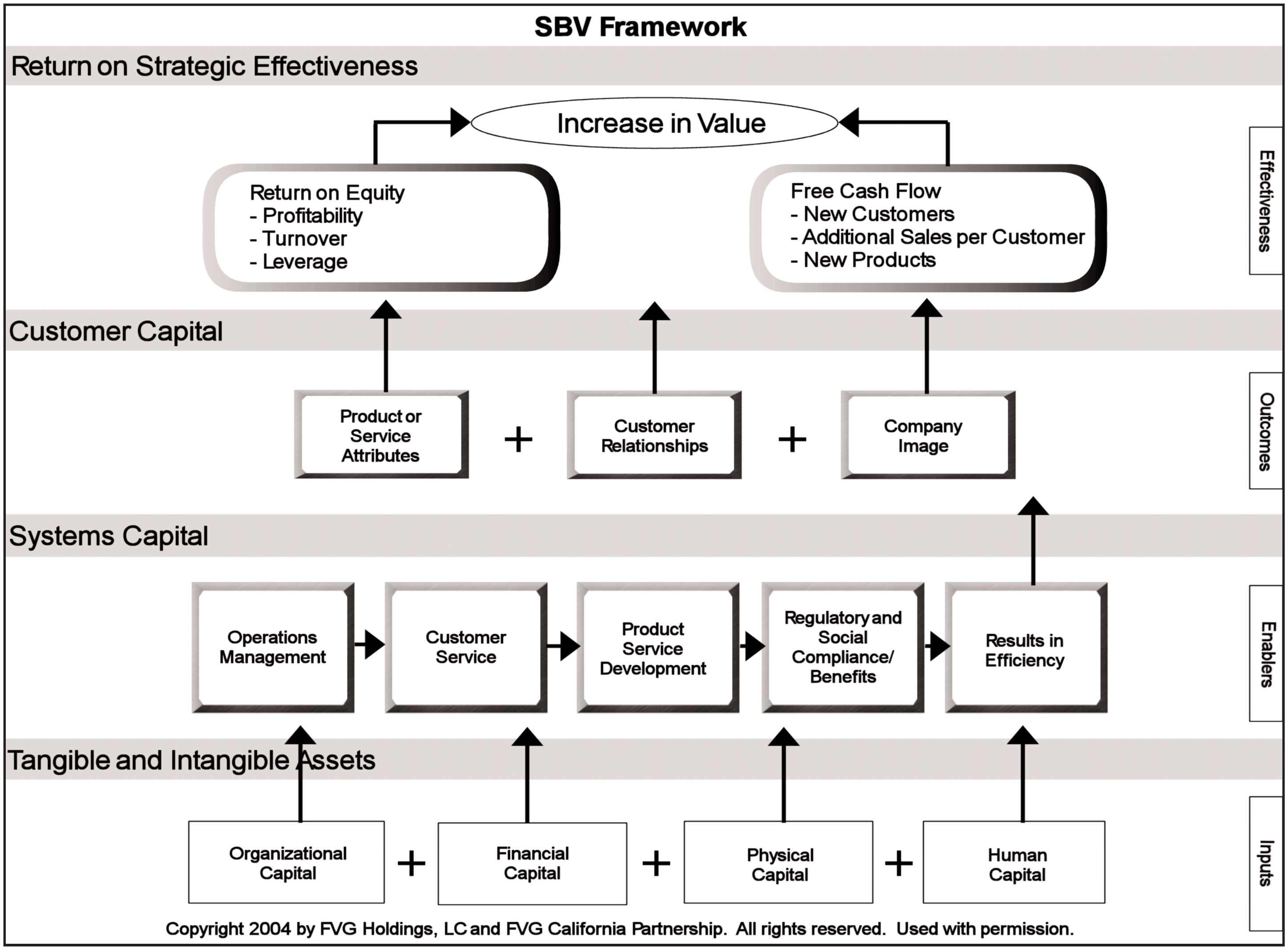
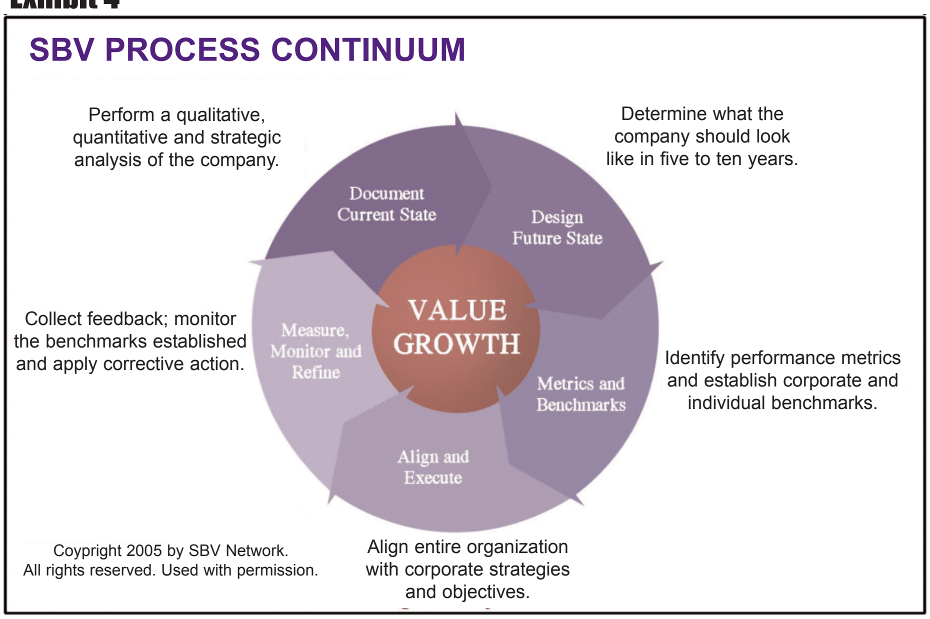


Exhibit 4



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The SBV Network calls the relationship between return on equity (ROE) and free cash flow (FCF) the Return on Strategic Effectiveness (ROSE) which is an analysis that tells us whether the company's value is going up or down and why.

Introduction to Data Choices in the Income Approach to Value

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I recall a study conducted several years ago that indicated that one or more income methodologies are used independently or in conjunction with other approaches to value roughly 90 percent of all closely held businesses. When I utilize the income approach for a closely held business valuation assignment, I immediately begin to consider all of the subjective inputs required to derive a supportable value.

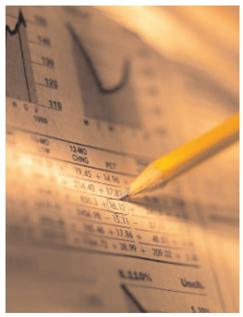
The subjective elements encountered in most income approach assignments include:

- The choice of which economic benefit stream to use, including cash flow, free cash flow, accrual-based earnings or some other measure
- The various normalization adjustments required for the economic benefit stream selected for specific income and expense items
- Whether or not to tax affect the adjusted economic benefit stream and if so, what tax rate or rates to use
- The financial model choices made to derive the capitalization or discount rate to be applied to the adjusted economic benefit stream, including CAPM, modified CAPM (MCAPM), or the build-up model (BUM)
- Risk premium information:
  - ✓ Whether to use the Duff & Phelps Risk Premium Report data
  - ✓ The many choices for the size premium from Ibbotson
  - ✓ Whether to apply the supply side risk premium information
  - ✓ Whether to use the relatively new Ibbotson Associates industry risk premia
- The analytical approach used to derive and support specific company/unsystematic risk

Each of these aspects will provide the basis for future articles.

DUFF & PHELPS

Many valuation analysts have consistently relied on the empirical evidence published by Ibbotson Associates (IA) to derive their choices for an equity risk premium for the market (RPm) and size premium (RPs) within the context of developing a discount rate under either MCAPM or BUM. However, the Duff & Phelps (D&P) risk premium study developed by Roger Grabowski of D&P and David King of Mesirow Financial Consulting has gained a growing following as an alternative or supplement to using data available from IA (now itself part of the Morningstar organization).



For those who are not familiar with the D&P study, it was previously referred to as the Pricewaterhouse Coopers study and more recently the Standard & Poors study. The D&P Study can be downloaded in Adobe .pdf format for a $100 fee from the Ibbotson Associates Cost of Capital website (http://www.ibbotson.com). The current available version contains data through September 2004. Companies are divided into 25 different size groups based on the following eight criteria for measurement:

- Market value of equity
- Book value of equity
- 5-year average net income
- Market value of invested capital
- Total assets
- 5-year average EBITDA
- Sales
- Number of employees

The study consists of two parts, with the first focusing on historical stock market returns based on the above alternate measures of size. Part 2 analyzes risk based on other entity performance measures by comparing historical returns in relation to certain benchmarks, including operating margins and coefficient of variation in operating margins and returns on equity.

The obvious top benefit of the D&P information is that it provides a broader set of choices for aligning the valuation target to the above criteria. It also narrows the size strata themselves, which is particularly relevant for smaller valuation targets.

In future installments, I will provide a more in-depth look at the D&P study, including practical suggestions on how to apply the data. I will also explore the other subjective judgment areas identified above with a goal to identify the choices and provide insights on how best to select data in practice.

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The Duff & Phelps risk premium study may enhance your cost of capital calculations.

Resolving Tough Spots in Family Matters: Collaboration for Equitable Resolutions

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Some say that time is the best healer for severe emotional struggles. For some, emotional scaring may last a lifetime while for others a much shorter recovery period is required. For most, settling family disagreements peacefully and equitably is the preferred mechanism. The financial analyst often sees families struggle the most in divorce and probate matters.

Visualize an arrangement where the crucial mission and charge of the analyst is to provide a basis for a reasonable settlement to all the parties—not simply to appraise or calculate the "value" of a property or interest, but rationally focus the parties on an impartial resolution. This type of engagement entails elevated consequences compared to being co-retained or providing an unbiased analysis of the property interest claim on value.

Case-specific, collaborative engagements are a growing segment of financial and valuation services requiring collaborative training as well as outstanding communication skills. These engagements are referred to as collaborative law and/or collaborative process services.

In a collaborative engagement, the financial analyst will be asked to interpret relevant facts, standard of value, methodology, substantiation and reporting. The analyst will have an ethical obligation of maintaining integrity and objectivity to the process as well as to the parties and others. Additionally, in the collaborative process, the analyst must maintain neutrality, thereby safeguarding the collaborative process as well as providing the valuation. There is also a duty to disclose relevant irregularities in the financial reporting or operations of the business as a requirement of the collaborative process. This requirement cannot be subrogated to others. As a result, the analyst cannot testify in any subsequent litigation proceeding should any of the parties elect out of the process and proceed to court.

A case-specific engagement might include being asked to be the business valuator for a divorcing couple who jointly own a closely held business. The analyst would use approaches and methods to reasonably achieve a range of value indications. The party who is actively involved in a small business may feel that the value should be lower. The other party may feel that the value should be higher. Somewhere in this array should be the "equitable" range of values to be utilized in the settlement process. Maintaining neutrality during this process is paramount to the success of a "collaborative" settlement.

As judges and juries are allowed broad power over interpretation, so is the financial neutral in a collaborative divorce and probate matters. The collaborative process allows the disputing parties a more engaging role in developing settlements they consider more suitable in their case. In collaborative cases the divorcing parties have the ultimate say in what is equitable, and their prevailing attitude reigns, not necessarily following that of the family courts, family code or guidance of their legal, mental health or financial counsel.

For marriage dissolution and probate purposes, it should be made clear that the collaborative process does not make the evaluation or division of personal assets less difficult; rather it provides an environment of fewer restraints than those of the judicial court system. Since arguably some advantages to the collaborative process over a divorce proceeding in court are increased party involvement and commitment by both parties in reaching a resolution, the clients are often more eager to embark on this process. The more opportunity the parties have for informed individual input and decision making, the more likely the chance of success in reaching a mutually agreeable resolution in a family friendly environment.

A question for the analyst in a collaborative engagement might be: If the analyst were one of the "parties" or "clients" and traded places with them, would the valuation outcome be similar?

If you would like to learn more about collaborative law, please visit www.collaborativelaw.com.

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Financial experts can assist in the collaborative process, which allows the disputing parties a more engaging role in developing settlements they consider more suitable in their case.

Financial Models: IP Valuation vs. IP Damage Measurements

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This article compares and contrasts financial models used when valuing intellectual property (IP) for transactional and other purposes and when measuring IP damages. Some of the general areas of attention in building these models are:

- Discrete versus infinite time horizons
- Prospective versus retrospective viewpoints
- Tax treatments of income or cash flows
- Capital charges or incremental profits

History and Finance Theory of the Discounted Cash Flow (DCF) Model

Financial models in IP matters are often present-value models, with the most common being the discounted cash flow model. The DCF model has a long history. Investors used DCF models in the 1700s and 1800s for land investment.[1] Dr. John Burr Williams was among the first to formally describe the model to value equity securities in his book *The Theory of Investment Value* in 1938. It was not until the 1980s and 1990s that the DCF model became popular in finance practice in the U.S.[2]

Modern finance theory says the value of something today is its expected future benefits that one discounts for some opportunity cost. The discount factor reflects the time value of money and investment risk or, expressed differently, some foregone opportunity cost.[3]

Models for Valuing an IP Asset Used by an Operating Company

If the objective is to estimate a fair market value, the analyst will place great emphasis on future expectations for a prospective view. When the IP is part of an operating company, one may use the DCF model and disaggregate the business's total income to identify only the cash flows from the IP asset. (We discuss the relief from royalty model later.)

A residual income model is one methodology to isolate the cash flows attributed to an IP asset, intangible assets collectively, or some other component of a business. This model has an established history. General Motors used it as early as the 1920s to evaluate business segments.[4] The U.S. Department of Treasury also used this model in the 1920s to pay distillers and breweries for the lost value of intangible assets resulting from prohibition laws.[5] In 1968, the Internal Revenue Service described the model as a way to value intangible assets for tax matters in its Revenue Ruling 68-609.[6]

When valuing IP using the residual income model, one commonly forecasts the company's after-tax operating cash flows over a period of several years. The next step isolates the cash flows attributed to the specific IP asset. In doing so, the analyst makes reductions from the company's after-tax operating cash flows for capital charges on all the assets used to generate the cash flows other than the IP asset being valued.

The remaining amount, the residual income, is an estimate of the after-tax cash flows attributed to the IP asset. Exhibit 1 (example only) illustrates this process.[7] The remainder of the model is a series of present-value computations. Once the analyst estimates the future residual cash flows from the IP asset, he or she discounts the cash flows to the present using a risk-adjusted discount rate.[8] The analyst also adds the present value of any terminal value of the IP asset, if there is one. The total of the present values represents the value of the IP asset.

When valuing an IP asset, one must also consider the length of time the IP will generate cash flows. Some IP assets are more likely to have longer lives than others. For example, a patent has a finite legal life, and thus, the model will be for a discrete number of years simply because its

EXHIBIT 1 - RESIDUAL CASH FLOWS ATTRIBUTED TO THE IP ASSET

		Year 1	Year 2
After-tax operating cash flows of the business		$10.0	$11.5
Less: Capital charges (returns) on assets			
Working capital	6%	0.3	0.4
Land and buildings	7%	1.2	1.2
Equipment	9%	1.0	1.0
Software	18%	1.1	1.1
Trademarks	17%	2.5	2.5
Assembled workforce	16%	0.8	0.8
Customer base	19%	0.9	1.0
Total		7.8	8.0
Residual cash flows (returns) attributed to the IP asset		$2.2	$3.5

legal protection will cease.[9] On the other hand, the U.S. government grants legal protection to a trademark as long as one uses and maintains it. Accordingly, a trademark may have a terminal value due to a perpetual life, and one will construct the DCF model accordingly.

In summary, an analyst may use the DCF model to value an IP asset by applying modern finance theory that relates the value to an investor's required rate of return (i.e., the discount rate) to the future cash flows attributed to the IP. These cash flows are prospective and normally incorporate expectations about the company, industry, and economy. The rate of return considers capital markets and the risk-reward relationship.

Models for IP Damage Measurements

Damage measurements in IP litigation can take several forms. This article discusses two models:

- Lost profits of the injured party
- Reasonable royalties

Damages are part of a legal process and are subject to any applicable statute or case law. We discuss these damage models in broad terms since it is not possible for this article to consider every legal case or the nuances for each type of IP.

IP Lost Profits

IP lost profits damage models usually have more focus on the past because the court will likely order an offending party to stop the wrongful activity (e.g., infringement).[10] Therefore, the analyst spends more time looking at historical data rather than forward-looking information as done for transactional and other valuations. This historic focus is similar to accounting activities. IP damages may continue past the date of trial either because the IP has been destroyed or damages are ongoing. In these cases, the model will frequently be limited to a discrete period often based on the economic or legal life of the IP asset.

Courts tend to consider information ex post through the date of trial for lost profits damages even if the measurement date is before the trial. On the other hand, analysts consider information ex ante for transactional valuations. Accordingly, they only consider information that was known or knowable on the valuation date. For example, a lost profits damage measurement would typically use actual incremental margins, but a valuation would use anticipated margins as of the valuation date.

Models for IP lost profits damages usually focus on incremental differences of the various model elements. These incremental items may include lost unit sales, lower unit prices, lost sales of ancillary products, higher production or advertising costs, and extra expenses. Lost profit models usually identify the incremental costs associated with the lost revenues. Incremental costs may be different from variable costs, which are usually the focus of transactional valuation models. Variable costs are those expenses that vary in direct proportion to sales volume. However, exceptions are not unusual. For example, costs may vary only at certain production volumes but exhibit fixed-cost characteristics at other production levels.

Alternately, variable costs may increase at a slower or faster rate as volumes increase and vice versa. Lost profit models focus on those costs that vary at the production levels under the set of circumstances. This may require a detailed accounting analysis rather than simply identifying variable costs based on a description such as "cost of sales." In this example, the company's accountants may have allocated factory overhead to cost of sales. This treatment is full absorption accounting. However, certain overhead expenses may not vary at the reduced production levels in the lost profits model if they are fixed costs.

Another model factor relates to taxation. One will usually model pre-tax cash flows in damage measurements rather than after-tax, because damages are taxed (in the U.S.) at the time the injured party receives the award. Therefore, the offending party will pay damages for the pre-tax lost profits. The injured party will then pay the appropriate taxes to the government.

Another element of the IP lost profits damages model is the damage period. The court will ultimately determine the appropriate period based on the facts and law. However, the analyst will consider an appropriate length of the time for the model.

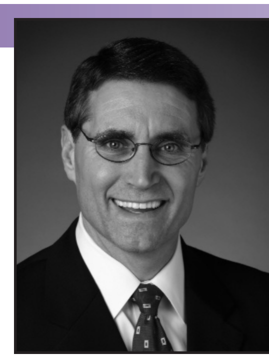
Since IP damage measurements relate to legal claims, the appropriate requirements apply. One important legal principle is that the injured party must prove damages with "reasonable certainty." This means the court imposes a burden on the injured party to prove lost profits damages with reasonable certainty. This burden does not normally exist outside of the courtroom, where standards for proving estimates may be lower. This difference may require the analyst to obtain more evidence about the company and the market for the product to support the models' estimates as compared to what may be necessary for a transactional or other valuation. If the analyst relies solely on management's estimates without additional scrutiny or analysis, a court could find them speculative and disregard the resulting opinion.

Models Using Royalties for IP Damage Measurements and Valuations

A model used in both IP transactional valuations and damages relies on royalties rather than the earnings (total or incremental) from selling the products or services that employ the IP (see pages 10-11 for more information). Analysts use a royalty model to value an IP asset by determining the present value of estimated royalty payments the company would hypothetically pay in the future, assuming it did not own the IP and had to license it. By not needing to pay the

Continued on page 27

THE DAMAGE PERIOD: A Key Component in Economic Damages



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Reliable damage calculations in commercial litigation properly consider several key elements: a harmful act (proximate cause), the economic effect of the harmful act and the appropriate damage period. Proximate cause is often the domain of the litigator in the case. The financial expert is charged with the quantification of economic damages, which requires an assessment of an appropriate damage period. The damage period is a key component in the proper measurement of economic damages.

Generally, the damage period (and the resulting economic loss) can best be measured by reference to one of the following fact patterns: temporary impairment of the business, destruction of the business, or slow death of the business.

Temporary Impairment

Lost profits represent the difference between what a business would have earned with and without the defendant's allegedly harmful act. The damage period is the period in which the defendant behaved in an injurious manner, or for the period in which the plaintiff suffered a loss of profits. Temporary impairment can occur in the context of a plaintiff's allegation of the breach of a contract of fixed term. In such a fact pattern, the plaintiff's damages should be limited to the profits lost during the term of the contract. Exhibit 1 (p. 19) depicts a typical example of lost profits for temporary impairment.

In *Mark Seitman & Assoc., Inc. v. R.J. Reynolds Tobacco Co., 837 F.2d 1527, 1529* (11th Cir. 1988), Reynolds entered into a five-year contract to sponsor a tabloid to be published by Seitman in exchange for being the exclusive advertiser. Seitman had no other tabloid business apart from the Reynolds contract, and Reynolds could terminate the contract by giving notice on or before March 1 of any contract year. A jury found Reynolds' premature termination of the contract to be wrongful. The lower court awarded Seitman lost profit damages in the amount of the value of the business plus out-of-pocket close-down costs. The appellate court reversed and limited damages to lost profits for the remainder of the contract term until the point at which Reynolds could properly terminate it. The appeals court reasoned that loss of business value was not an appropriate measure because Seitman's tabloid business only had value to the extent Reynolds chose to renew the contract, which in fact, it did not do.

Destruction of the Business

Published court cases reiterate the general principle that when a business is destroyed, the market value on the date of the loss is the proper measure of economic damages. This principle is clearly stated in *Aetna Life and Casualty Co. v. Little, 384 So. 2d 213* (Fla. Dist. Ct. App., 4th Dist. 1980). Implicit in this principle is the recognition by the court that the business was a going concern. Exhibit 2 (p. 19) depicts a typical case of the destruction of a business.

Slow Death

This scenario is a variation of the destroyed business, in which the injurious behavior of the defendant causes a business to suffer lost profits for some period of time but then ultimately destroys it. In such circumstances, a combination of lost profits and loss of business value may be appropriate. Exhibit 3 (p. 19) depicts a typical slow death scenario. This fact pattern was present in *City of San Antonio v. Guidry, 801 S.W. 2d 142* (Tex. App. 1990). Guidry's restaurant suffered a severe loss of business due to restricted access during street construction and ultimately closed. The court held that Guidry was entitled to recover lost profits for the time period prior to the closing and loss of business value as of the date of closure. As always, the facts and circumstances of each case need to be considered.

Most business damages cases fall into one of the three general fact patterns described above. In each, the damage period is a key component to the proper measurement of economic damages. Proper measurement of the appropriate damage period will prevent the calculation of different types of damages over the same time period and consequently, maintain the credibility of the damage calculations. Damage calculations that properly consider and reflect the fact pattern of a given case will possess a higher probability of withstanding the scrutiny of the rebuttal expert and the rigor of cross examination.

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Three general damage periods:

1) Temporary impairment

2) Destruction of the business

3) Slow death

Exhibit 1* - Lost Profits vs. Loss of Business Value
Temporary Impairment:

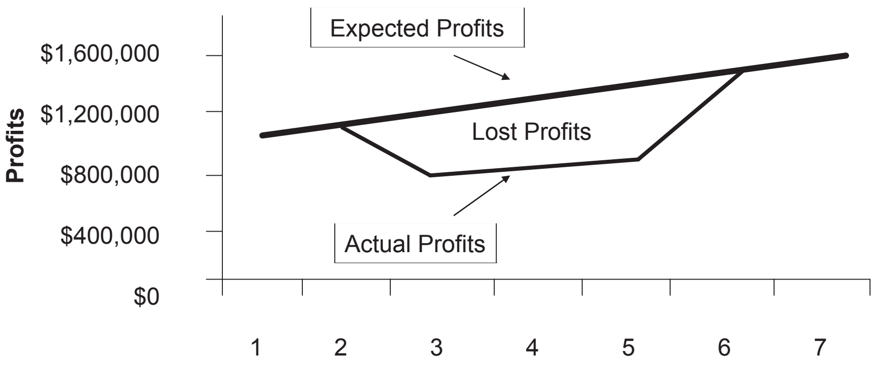


Exhibit 2* - Lost Profits vs. Loss of Business Value
Destruction of Business:

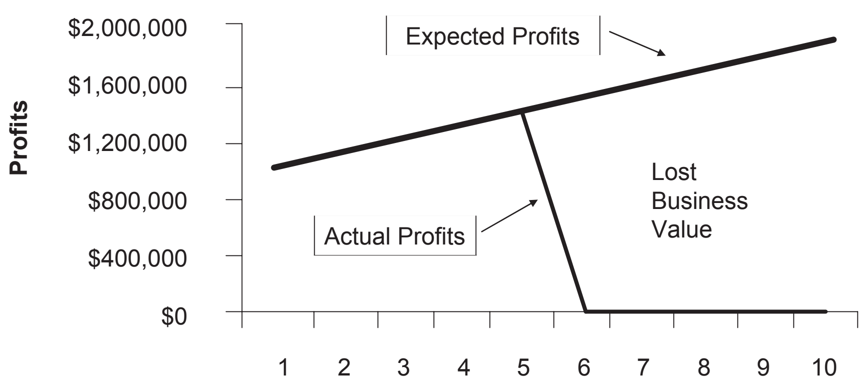
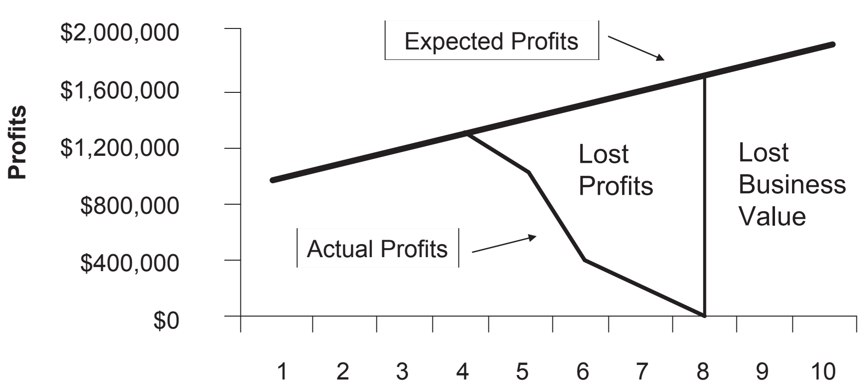


Exhibit 3 *- Lost Profits vs. Loss of Business Value
Slow Death:



*Adapted from James R. Hitchner, *Financial Valuation Applications and Models* (New York: Wiley and Sons, Inc., 2003), pp. 838-839.

[1]Janette Rutterford, "From Dividend Yield to Discounted Cash Flow: A History of UK and US Equity Valuation Techniques," *Accounting, Business and Financial History 14*, no. 2 (2004), pages 115-149.

[2]Ibid.

[3]Richard A. Brealey, Stewart C. Myers, and Franklin Allen, *Principles of Corporate Finance* (New York: McGraw-Hill-Irwin, 2006), pages16-17.

[4]John D. Stowe, *Analysis of Equity Investments: Valuation* (Charlottesville, VA: CFA Institute, 2002), page 262.

[5]The model was described in "Appeals and Review Memorandum 34" issued in 1920, ARM 34, C.B. 2, 31.

[6]In ARM 34 and Revenue Ruling 68-609, the guidance valued intangible assets collectively.

[7]The residual income model to value a specific IP asset requires the values of any other intangible assets to be determined first. See Mard, Hitchner, Hyden, Zyla, *Valuation for Financial Reporting: Intangible Assets, Goodwill, and Impairment Analysis, SFAS 141 and 142,* (New York: John Wiley & Sons, 2002) for illustrations of ways to value various types of intangible assets.

[8]A discussion of discount rates is beyond the scope of this article.

[9]The economic life may be shorter than the legal life.

[10]The general lost profits damage model subtracts foregone incremental costs from lost revenues in arriving at lost profits.

[11] *Georgia-Pacific Corp. v. United States Plywood Corp., 318 F. Supp. 1116* (S.D.N.Y. 1970), modified, 446 F.2d 295 (Second Cir. 1970), cert. denied, 404 U.S. 870 (1971).

see page 40

What's in a Name?

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I am pleased to take up my post as a regular columnist for this fantastic "new concept" publication.

What better way to start off than by talking about "What's in a Name?"— a tradename to be specific. In a recent litigation engagement, my firm was asked to rebut the report of another expert claiming damages for infringement of tradename for a restaurant. Let's say that the name of the defendant's restaurant chain was "Danny's Real Good Eats." Let's also say that the plaintiff's chain was called just "Real Good Eats."

Real Good Eats is a multi-state chain, and Danny's Real Good Eats is a regional chain that operates in only one state. Beside the obvious issue as to whether the term "real good eats"is generic and in the public domain, the real issue for us as a rebuttal expert was to examine the efficacy of the arguments used by the expert for the plaintiff in determining damages.

Both parties agreed that the defendant's restaurants operated at a loss during the period of purported infringement, so an award based on profits was not appropriate here. Therefore, the plaintiff's expert was left with the application of a reasonable royalty to the asserted infringing revenue for determination of damages. The determination of the reasonable royalty rate is where the plaintiff's expert's report fell short.

In reviewing the "guideline" companies that plaintiff's expert used, it became apparent that none of the guideline companies were retail restaurants. Instead, all of the guideline companies were either wholesalers to the restaurant industry or producers of products used by the restaurant industry.

The cost and profit structures of these companies are different from a restaurant. Therefore, in this case it was not appropriate to use those other companies as comparables to determine a reasonable royalty rate to be applied to a retail restaurant.

The plaintiff's expert also applied the principles of the Georgia Pacific case to determine a reasonable royalty rate. That case applies to patent infringement and not necessarily to trademark infringement.

The lesson to be learned in all of this is that as an expert it is important that you have a clear understanding of what it is you are analyzing and assessing in either valuation or determination of damages. A guideline company or a guideline asset or transaction (royalty) may not be exact, but it should be reasonably similar. It is an elementary mistake to compare companies in a completely different line of business in the determination of a reasonable royalty rate when other companies that are more similarly aligned to the specific industry are available. If you were valuing a retail company using a guideline company method, you would usually not use companies who are wholesalers and manufacturers as guideline companies when guideline retailers exist. The same principles apply in the intellectual property arena.

expert TIP

While experts may disagree somewhat on guideline "comparable" companies or royalty rates, there must be a reasonable amount of similarity for a supportable result.

FINANCIAL EXPERTS:
A Powerful But Underused Tool in Mediation

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Mediation, if approached properly, can be a powerful tool in the resolution of disputes. Unfortunately, mediation is often treated as the stepchild of the litigation process. Litigants who are directed to court-ordered mediation sometimes consider the process to be nothing more than an admission ticket to the court's trial calendar.

In those matters in which the parties have agreed to voluntary mediation, it is likely that they will approach the mediation with a clearly defined bottom line and an anticipation that their adversaries will never agree to it. With minimized expectations as a backdrop, the process often translates into an exercise of posturing by counsel, which is punctuated by the question, "Why did we come here to begin with?" Preparation for this type of mediation is usually minimal and rarely involves the participation of the experts.

A common obstacle to the optimistic attitude toward mediation is the vested interest that trial counsel has in the evolution of the proceeding. In practice, mediation often occurs near the end of the discovery period at a time when the attorney's thought process is focused upon positioning the case for trial. It may, therefore, be difficult at this point on the timeline for an attorney to shift his or her thought process into a settlement mode, as the suggestion of mediation may be perceived as a sign of weakness or a lack of confidence in the case.

Additionally, many litigants have difficulty understanding why their attorneys suggest pursuing a settlement forum after months or perhaps years of reassurance of the strength of their cases. These thought processes can make it much easier to continue to prepare for "war" when "peace talks" would best serve the interests of the litigants.

Sometimes mediation is approached as the powerful tool that it can be by attorneys and parties who truly believe that a satisfactory resolution can be reached without incurring the expense and emotional energy that accompanies trial. Most importantly, the optimistic approach to mediation is founded upon some key principles. Among them are the following:

1. There is a possibility (no matter how hard it may be to believe) that the client may lose in trial.

2. There is benefit to be gained from the litigants hearing each other's story directly. The information channeled through counsel may have had important components deemphasized or filtered out.

3. Professional mediators have effective tools that can actually facilitate the communication process.

4. Creative approaches, often unavailable to judges and juries, can be employed in mediation.

5. A solution that involves the parties has a better chance of being equitable and can occasionally lead to a "win - win."

Is there a role for a financial expert in this part of the litigation process? Is there something to be gained from involving one, who has prepared to render and defend an opinion in court, in the mediation process? Will the expert's involvement not be tantamount to free discovery?

The answer is that the financial expert can be called upon to provide many perspectives in a mediation setting that he or she would not normally provide at trial. During mediation the opposing financial experts can discuss their respective analysis with each other, answer each other's questions, and reconcile the data and assumptions leading to the differences in their opinions.

This discussion allows each of the experts to identify the strengths and weaknesses of each analysis, examine understandings and misunderstandings regarding the foundational financial information, and relay important information that one of the other experts failed to consider.

In addition, the financial experts can provide risk analysis, which can help the attorneys and litigants comprehend the likely financial value of the case. This process commonly leads to a significant narrowing of the gap between the experts' opinions. ❧

expert TIP

When complex accounting, valuation, damages or other financial issues are involved in a mediation, the probability of a satisfactory resolution is enhanced when the financial experts are included in the process.

5 Tips for Marketing and Managing a Practice

1. Word of good work travels fast; word of bad work travels faster.
2. Good work sometimes goes unnoticed; unfortunately, bad work often goes unnoticed too.
3. Inexperienced staff should check in with a senior person at least twice a day.
4. Leverage your marketing activities; e.g., write an article, speak on it, send it to clients and prospects.
5. When trying to sell services to a client, talk less than 20% of the time. It should be mostly questions to show you care about the client's needs.

FETCH XL

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What is the most despised task in creating a business valuation report? It has to be data entry, especially when you are laboriously entering all the publicly traded company data into a spreadsheet for a valuation using the market approach.

Fortunately, there has been progress in this area. In recent years, it has become much easier to download publicly traded company data, but there are still glitches in getting the information formatted and working properly with your own templates.

FetchXL, introduced in 2005, is a flexible, easy-to-use solution for downloading publicly traded company data. FetchXL (www.fetchxl.com), is a data retrieval tool for Microsoft Excel designed to automatically populate financial models.

FetchXL is an extension of Excel that can be used just like any of Excel's native functions (i.e., IRR, PMT, SUM, SUMIF, etc.). All of Excel's functionality can be applied to FetchXL data, including macros, conditional formatting, and scenarios.

The FetchXL add-on for Excel incorporates the Hemscott database, with access to more than 20 years of financial and market data for upwards of 9,000 U.S. and 3,000 Canadian companies. The Hemscott database covers 750 annual and quarterly fundamental data points, so chances are the specific metrics you need for your analysis are there.

So how does FetchXL work? Pretty slick. You select the data points you want to see— e.g., revenues, earnings per share, etc.— then enter the ticker symbols and dates, and FetchXL does the rest, populating your spreadsheet.

FetchXL works with your own spreadsheets, or you can choose a template from the FetchXL library.

At first glance, your FetchXL spreadsheet looks just like any other Excel spreadsheet, but a peak into a cell with a formula reveals a different picture. In cells containing the financial data items of a company, the formula will look like this =Fetch ("Ticker Symbol," "Data item," "Date").

In the example =Fetch ("FDX," "Operating Revenue," "2003"), the Fetch function is looking to the Hemscott database to populate this cell with the 2003 Operating Revenue for FedEx. The Formula Builder function, which appears as a button on the toolbar, allows the user to select from a list of data items and dates, making it easy to construct any formula.

expert TIP

If you are looking for a way to free yourself from data entry drudgery, FetchXL is a productivity tool that is worth a try.

Bingham Says...

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I'm flattered to have been given this space. Writing for such a capable audience is both challenging and fun, so let's get started.

I thought I'd cover one of the bigger issues that valuation analysts face in the courtroom: justifying the guideline public company method of the market approach to a judge, jury or opposing counsel. We've all heard the refrain, "How can you testify that Megacorp ('Mega') is comparable to Minico ('Mini')? Mini is smaller, local, run by a family, has no access to capital, yada yada yada." Here are some thoughts on how to deal with this.

First, make sure everyone knows the definitions of the market approach and the guideline public company method and why they are used. Articulate that even the IRS in Revenue Ruling 59-60 advocates this approach and that the primary reason we are using Mega and other comparable guideline public companies ("comps") is because only public companies make financial data available that can be correlated to a known value.

Next, explain how you found your comps. Start by defining your search criteria, establishing the universe of comps, and working your way down. Itemize your selection criteria logically, and keep in mind the audience that will be hearing you. Don't make it look like you are cherrypicking the criteria to suit your analysis.

Another important factor is to demonstrate that you have identified all of the companies within your search criteria. You do not want the other side to confront you with comps within your universe that contradict your opinion. I once took a looseleaf binder with 300 marked-up software company descriptions into a hearing and showed how I had evaluated each company's description to determine five finalists. The opposing expert witness used Microsoft, Apple, and a few other major Megas with little or no justification and was completely ineffective.

Size can often be dealt with, but more importantly, try to make sure your comps have similar financial performance. It not, make adjustments or eliminate. If Mini has had a mixed history, don't use companies that have been profitable for the past 10 years without some adjustment. On the topic of size, try to avoid using the very biggest public companies, as that opens you up to sarcastic remarks from opposing counsel and really stretches the audience's capability to accept the method, whether valid or not. I use the existence of Ibbotson's size premium studies to demonstrate that there is a highly regarded industry resource that actually studies this topic extensively. (More on the interaction among the approaches a bit later.)

Fundamental Discounts

Explain the concept of fundamental discounts, or "haircuts," to the multiples of your public comps. Often, private companies are inferior in head-to-head comparisons with public companies. There are quantitative as well as qualitative factors to consider in any comparison that can justify a haircut.

One method often used by analysts is to take an appropriate haircut for each multiple by a proportional analysis of the comps and the target. Other analysts take an average of the multiples, compare the subject company to the average performance of the comps, and then take a fundamental discount from the average multiples. In litigation, as an expert you are expected to be able to justify those items that are deemed to be more subjective.

Using Risk Premium Data

If the concept of haircuts is to reflect the differences between the public comps and the target, what we are really doing is reducing the public company multiples to reflect the additional risk inherent in the private target company. Sound familiar? Think now about how you develop your discount rate in the income approach. I have made the point in past testimony that there is and should be some proportionality between the size premium and the specific company risk premium used in the MCAPM and build-up and the haircuts applied to multiples in the guideline public company method. Using a rough and hypothetical example (I'm sure I'll see this on the stand sometime in the future, so, again, this is just an example to show the overall proportionate movement of these two entities!), if you add a 5 percent specific company premium to a 15 percent equity capitalization rate, that is proportional to a 25 percent haircut to an equity multiple for additional specific company risk.

Our valuation world may be clear and logical to us, but there are some policies and procedures that make the rest of the world confused and/or skeptical. The more you can show the logical trail from the start of your analysis to the finish and how your opinions are derived, the better your chance of prevailing.

expert TIP

Taking a fundamental discount to public company valuation multiples adjusts for higher risk in the subject company.

What's Happening at the ASA?

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Editor's Note: Each issue of FVLE will include a "What's Happening at the …" column for one business valuation, forensic/fraud or litigation committee or association. I am proud to present Mike Hill Jr., ASA, CPA/ABV, who is chair of the American Society of Appraisers (ASA) business valuation committee. The next edition of FVLE will feature Bob Grossman, incoming chair of the executive advisory board of the National Association of Certified Valuation Analysts (NACVA).

As the title suggests, I will be reporting periodically on the activities and events of the American Society of Appraisers (ASA) and more specifically, the ASA's Business Valuation Committee (BVC). For those less familiar with the ASA, it is the oldest and only major appraisal organization representing all of the disciplines of appraisal, including business valuation, real property, machinery and technical specialties, personal property, and gems and jewelry. Business valuation currently represents over 40% of the ASA's total membership.

GOVERNANCE CHANGES

In ongoing efforts to ensure long-term health and growth, the ASA's Board of Governors passed several resolutions last year that will change how the ASA is governed. Many of these changes focus on moving the ASA from its current geographic-based structure to a more discipline-oriented one. These changes are outlined in a new procedural guide that can be accessed in the "Members Only" section of the ASA website (www.appraisers.org). The changes will be effective July 1, 2006. Some of the key provisions are as follows:

1. Members will now be able to select the chapter to which they wish to belong, including new virtual chapters or chapters focused on disciplines, areas of practice or specialties.
2. The 14 current geographic regions will be dissolved and reconstituted into five new regions. Each geographic region will elect one governor from its membership.
3. In addition, two governors from each discipline will be elected by the discipline membership (currently the discipline governors are appointed by the discipline committees). This means that each member will now get to vote for three governor positions (1 regional, 2 discipline).
4. Nominees for governor positions will be selected by regional/discipline nominating committees or by a petition signed by 50 or more members in their region/discipline.
5. The Assembly of Delegates will be dissolved and replaced with annual Town Hall Meetings, in which all members are invited to attend and participate in the discussions.
6. Discipline committees will now be responsible for education (course development, content, materials and instruction). Logistical support will be provided by ASA headquarters with the concurrence of the discipline committees.
7. Discipline committees must develop and submit annual budgets and business plans.

CONGRESSIONAL TAX BILLS

The BVC is currently working to support the important appraisal reforms contained in the Senate version of the tax bill, which would:

1. Revise the IRS' ("Service") current ineffectual definition of who is a "qualified appraiser" by requiring individuals who value tangible and intangible property for tax purposes to have meaningful valuation credentials in the type of property being appraised;
2. Require that determinations of fair market value adhere to generally accepted uniform appraisal standards as well as any regulations promulgated by the Treasury Secretary; and,
3. Enhance the Service's ability to impose penalties and sanctions on appraisers and ease existing criteria for finding a "substantial" or "gross'' valuation misstatement.

In addition, we are strongly urging House and Senate conferees to extend the Senate bill's reforms to all tax-related valuations, not just valuations of non-cash charitable contributions as currently proposed. This would prevent the creation of two unequal sets of valuation requirements (charitable vs. non-charitable).

EXPOSURE DRAFTS OF INTANGIBLE ASSET STANDARDS

The BVC Standards Subcommittee has issued an Exposure Draft on a new Intangible Assets Standard and Intellectual Property Statement. Please take the time to read these drafts and send in your comments by June 16, 2006. Note that these standards are intended to provide a minimum criteria for developing and reporting the valuation of such assets and are not intended to be a "how-to" guide.

To review the drafts and submit your comments, please visit the ASA BV website at www.bvappraisers.org.

Innovation and Software Firms

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Even more than most businesses, software companies are going through a transition period that affects their business risks, revenue streams and values. Robert O'Conner, the president of Softrax Corporation, wrote in an article for the SandHill Group (Silicon Valley):

"Innovation is still the key to growth in the high tech business, but it has broader implications than in the past. Today some of the most important innovations are about the business model— how technology is being sold and delivered.

In fact, nearly 80 percent of the software CEOs surveyed at the Enterprise 2005 conference stated that business model innovation is equal to, or more important than, technological innovation to business success today. Software as a Service (SaaS), on demand, hosted, and subscription models are all reshaping key customer relationships for high tech companies."[1]

"Software as a Service" is not a new concept but is a repackaging of an old, failed business model given new life by advances in technology. Previously the most common name for SaaS was Application Service Providers (ASPs). ASPs failed for many reasons, most of which can be summarized by the model being ahead of the technology to effectively implement it.

SaaS is designed to solve key issues for both the software developer and the software user. The model is designed to assist the purchasing users with their cost to purchase, upgrade, and maintain the software (and its related hardware) and the developer's lack of reoccurring revenue.

For the users, the benefits are normally considered to be:

- Lower up-front costs for software and hardware
- Completely scalable, up or down, depending on the current needs of the user.
- Lower technology administration costs
- Faster implementation times
- Lower costs for multiple location usage
- Work (access) from anywhere
- Shared costs of higher-end databases
- No more backup worries
- Software upgrades provided on a regular basis

Another advantage for associations and user groups is the ability to develop a shared database of information. For example, the SBV Network (See "Company Analysis Tools," pages 12-13) will be providing online (SaaS) assessment software so value creation consultants can build a shared database of performance and alignment information as their clients complete the alignment and planning assessments.

Software developers can license the use of the software using a variety of methods creating a regular ongoing revenue stream. The licensing revenue models include:

- Subscription based model
- Usage based model
- Transaction based model
- Value based model
- Fixed-fee based model

SaaSs generally have one of the following emphases:

- A functional emphasis on a single application, such as credit card pro cessing or multiple location sales tax calculations
- A vertical market emphasis on a particular client type, such as law firms
- An enterprise emphasis delivering a broad spectrum of solutions
- A geographic emphasis on the vendors particular geographic area or
- A volume emphasis, low-cost, high-volume solution like Pay Pal

SaaS revenues for 2004 were estimated at over $4 billion by IDC. They are growing even faster as they begin to reach the desktop users.

Michael Robertson, the developer of MP3 for the audio files most of us use, just announced AjaxWrite, an online word processor to compete with MicroSoft's Word. The program may not have all the functionality you need, but it is estimated that its functionality will be sufficient for the vast majority of word processor users. And, best of all, it's free to use!

In SandHill Group's online pulse poll for technology company executives, the most popular answer to the question, "How fast will software as a service take over as the most popular method of pricing software?" was "one to two years." SaaS will completely change the dynamics in the industry and turn the industry's business risk factors upside down.

[1]SandHill.com, Opinion, "The Secret to SaaS Success," by Robert O'Connor, Softrax Corporation, Sept. 2, 2005.

expert TIP

Today's software company may not be able to compete in the near future unless it is prepared to make the change over to a Software as a Service (SaaS) model, at least for a portion of its client base.

A Brief Look into a Cloudy Crystal Ball: MedPAC's 2006 Report

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The Medicare Payment Advisory Commission (MedPAC) is perhaps the most commonly overlooked source of insight for forecasting future cash flows in the valuation of healthcare entities. MedPAC provides recommendations to Congress for changes in the reimbursement system for healthcare providers across all industry segments. Many valuation analysts working in the healthcare industry regard this as an important read.

In its March 2005 report, after several years of highlighting the explosion in high tech imaging services— magnetic resonance imaging (MRI), catscan (CT) and positron emission tomography (PET)— MedPAC recommended that the payment for the technical component of certain same day MR and CT scans of contiguous body parts be reduced. In the August 2005 preliminary rule, the Centers for Medicare and Medicaid (CMS) adopted this recommendation, although the effect was phased in over two years, when the final rule was published in November 2005. CMS also adopted MedPAC's recommendation that PET be added to the list of Designated Health Services under the Stark Laws, which will preclude physician investors from referring to units they have an ownership or financial interest in effective January 2007. Analysts may want to be cognizant of the MedPAC recommendations when preparing valuation reports after March of 2005.

Physician or Part B Services

With respect to physician or Part B services, in 2006 MedPAC once again is advising Congress to do away with the Sustainable Growth Rate (SGR) formula for setting the physician conversion factor (a dollar rate per Relative Value Unit or RVU) that Medicare uses to value physician services in conjunction with the Resource-Based Relative Value Scale (RBRVS), which establishes the RVUs for each service. The SGR is the source of the scheduled cutbacks in the value of physician services, which have been legislatively overturned for each of 2004, 2005 and 2006. In 2006, the conversion factor remained flat after legislation signed in February, repealing a 4.4 percent cutback that had already begun to be implemented. MedPAC's recommendation for 2007 is to increase the conversion factor by 3.7 percent based upon expected operating cost increases, less a factor for productivity growth of 0.9 percent, for a net increase of 2.8 percent. The alleged productivity growth is based upon a broad measure of economy-wide productivity that may not be experienced by the typical physician practice. Note as well that these expected cost increases are well above the generic CPI, something frequently not understood.

Among the many problems with the conversion factor methodology is that it is based on global factors affecting the many providers covered by Medicare Part B reimbursement, a problem explained in some detail by MedPAC. Thus, the enormous increases in high tech imaging utilization (15 percent or more for the last five years) negatively impact, for example, the payments to internists and family practice physicians, most of whom likely do not benefit from the explosion in imaging profits. Another problem for physicians engaged in the piece-work specialties is the continued ease of access to medical care by Medicare beneficiaries. MedPAC makes it clear that the move to increase physician fees to a fairer level would be accelerated only if physicians refused to accept new Medicare patients.

Of particular interest to valuation analysts is the other major recommendation: that the relative values of physician services contained in the RBRVS be overhauled. Further, MedPAC advised that an independent panel be appointed to supplement the work of the American Medical Association's Specialty Society Relative Value Scale Update Committee (RUC). Besides the revision advice, many commentators believe this is a veiled attack on the AMA's long-term dominance of the relative value-setting process.

MedPAC Reasoning

In explaining its reasoning, MedPAC once again provided significant detail on the increase in imaging services, noting that the relative value of those services covered by Medicare had increased by 2 percent, from 12 percent of total spending in 1992 to 14 percent of total spending in 2002. At least in this long-term observer's eyes, this suggests the potential for further devaluation of imaging services that should be a consideration in forecasting cash flows or the risk of cash flows. Two items of particular note are cited in the following quote from the report:

Technology diffusion affects average procedure time and intensity. Changes to average time and reported work will depend on how familiar providers are with a technology. Initially, average time and intensity may increase, as a growing number of physicians first begin to perform a

continued on page 27

service. Later, average time and intensity should decrease.

Technology substitution can reduce the time required to accomplish a task and raise the productivity and hourly wage of workers as physician work is replaced by machines. Computerized interpretation of diagnostic tests is an example of this phenomenon.

Imaging Technology Advantages

Certainly, there have been enormous advances in imaging technology, including the throughput time for CT and MR scans, the quality of the images and diagnostic software. The advent of the 64-slice CT Scanner for cardiac evaluation portends greater spending still. Meanwhile, there have been no such enhancements in throughput for patients in the typical primary care practice, other than being rushed out the exam room door and enhanced coding of services. This suggests that a revisiting of the RVUs may result in the Evaluation & Management Services receiving an increase in value comparable to what occurred in the last major revision in 1997's Balanced Budget Act.

MedPAC made two major recommendations with respect to physician services: the oft-suggested repeal of the SGR formula for setting the conversion factor; and a revision in the relative value of the thousands of codes used by physicians for billing, citing the growth in imaging as a rationale. Those of us valuing healthcare entities do well to watch how Congress reacts to what MedPAC has to say. ∞

expert TIP

The Medicare Payment Advisory Commission (MedPAC) is perhaps the most commonly overlooked source of insight for forecasting future cash flows in the valuation of healthcare entities.

expert TIP — **IP Valuation vs. IP Damages (in General)***

GENERAL FACTORS*	IP VALUATION	IP DAMAGES
Discrete vs. infinite time horizons	Discrete and infinite	Discrete
Prospective vs. retrospective views	Prospective	Retrospective
Tax treatment of income or cash flows	After-tax	Pre-tax
Capital charges or incremental profits	Capital charges	Incremental profit

* These are general differences, and there may be exceptions to what is presented here, based on the special facts and circumstances of a situation or engagement.

royalties to another party, the company's profits and value are higher. This valuation methodology is called the relief from royalty method.

One may use a royalty model as a measure of damages related to IP infringement. In this case, one measures the damages as the royalties the infringer should pay based on its improper sales and a reasonable royalty rate.

One distinction in the royalty models is that the variables are prospective for transactional valuations and retrospective for damage measurements. In addition, the tax considerations in the royalty models are different. Transactional valuation models use royalty amounts reduced for the tax effect (i.e., the after-tax royalty cost) and use these periodic amounts to estimate a present value of the IP asset. On the other hand, damage measurements use the amount of royalties without any reduction for income taxes since the injured party must pay income taxes on the award.

As discussed earlier, the burden for proving estimates in IP damage lawsuits is higher than for transactional valuations. In addition, case law may apply in certain types of IP lawsuits. For example, in patent infringement lawsuits, the *Georgia-Pacific Corp. v. U.S. Plywood Corp.* case identified 15 factors to consider in determining a reasonable royalty rate.[11]

Disgorgement of the Offending Party's Profits

This model measures the profits the offender earned from improperly selling the goods or services employing the IP. The claim is the offender was unjustly enriched. The damage theory takes the wrongfully earned profits and gives them to the injured party.

The model is retrospective and is similar to an accounting analysis. Laws may vary in defining how to calculate the profits. Unless contrary to law or the surrounding facts, full absorption accounting may be appropriate rather than incremental costs to measure the offender's actual profits.

Summary

Financial models for IP valuation in transactions and IP damage measurements are significantly different. Since IP litigation usually stops the wrongful conduct of the offender at the trial, IP damage models typically focus on historic activity. This makes the model and surrounding effort like an accounting analysis. On the other hand, IP transactional valuations are prospective and focus on the expectations of the business, industry, and economy. Another model factor that differs is the treatment of taxes. Since the government will tax damages that the injured party receives, IP damage models use pre-tax income or cash flows. Transactional valuation models use the company's after-tax amounts. ∞

(See page 19 for references)

Event Study Analysis Rejected When Other Possible Events Not Considered

In Penn Mart Supermarkets, Inc. v. New Castle Shopping, LLC, et al., No. 20405-NC (Del. Chan. December 15, 2005), the Delaware Court of Chancery rejected a lost profits computation based on an event study analysis that failed to consider all possible events that may have resulted in the lost profits. New Castle Shopping, LLC (New Castle) operated a shopping complex with two anchor stores and several smaller stores. Penn Mart Supermarkets, Inc. operated a Thriftway supermarket ("Thriftway" hereinafter) under a lease from New Castle in an anchor store location. The lease, which was executed in the 1940s with Thriftway's predecessor-in-interest, included a restrictive provision prohibiting any other lessee of New Castle from selling "food or food products intended for off-premises consumption."

The other anchor store was leased to Ames department stores. Following Ames' 2003 bankruptcy, the lease was assumed from the bankruptcy estate by NWL Holdings (NWL) and New Castle permitted NWL to operate a "typical NWL department store" from that location. The typical NWL department store included roughly 800 square feet devoted to the sale of non-perishable food and food products as well as perishable milk, eggs, and orange juice. NWL's store opened in May 2003.

Many of the smaller stores in New Castle's complex also sold food products for off-premises consumption, but this was limited to candy, popcorn, and the like. Furthermore, Thriftway executed a waiver of this protective provision with respect to a dollar store. Contemporaneously with the opening of NWL's store, several other significant events befell Thriftway: Thriftway's wholesaler declared bankruptcy, construction began on the road abutting New Castle's premises making access to New Castle's lessees difficult, and several newer grocery stores opened in the area which increased competition. Thriftway brought suit against New Castle and NWL for breach of the protective covenant in its lease. It claimed that as a result of the violation of the protective covenant, it suffered lost profits. Thriftway testified that the entire amount of the loss was attributable to NWL's competition. It engaged a CPA to compute its lost profits using that assumption. The CPA calculated the loss by using a simple calculation. He calculated the sales for the 52 weeks preceeding the opening of the NWL store and the sales for the 52 weeks following its opening. It subtracted the two to determine the gross loss, and reduced that figure by the average cost of goods sold (76.1 percent). He concluded that Thriftway lost $129,036 as result of NWL's violation of the protective covenant. NWL and New Castle contested the enforceability of the protective covenant as well as the amount of the loss attributable to it. It first claimed that the protective covenant was waived or otherwise unenforceable.

The court analyzed the scope of the protective covenant in light of the actual enforcement of the restriction since its execution. Because many of the stores sold a variety of non-perishable foods without the objection of Thriftway or its predecessor, the restrictive covenant with respect to non-perishable food and food products had been waived. However, the court found the protective covenant was not waived with respect to perishable foodstuffs and thus was enforceable against NWL and New Castle.

The Chancery Court then turned to the Thriftway's lost profits claim. The court found several problems confronting the reliability of the damage calculation.

First, it noted that Thriftway calculated its losses on an annual gross sales basis. In light of the court's determination that only perishable foodstuffs were protected by the covenant, the damage calculation was speculative because the damage calculation did not separately account for the losses by category of foodstuff. Therefore, the court lacked any information on the losses attributable solely to the sales of perishable foodstuffs.

Next, the Chancery Court noted that Thriftway and its expert attributed its entire loss to NWL's violation of the covenant. NWL and New Castle rebutted this assumption by submitting a copy of a filing Thriftway made in connection with its wholesaler's bankruptcy. That filing included an estimate of the losses Thriftway suffered between April and July 2003 as a result of the wholesaler's actions. The court found, "That … [the wholesaler] discontinued its supply of product to Thriftway shortly after NWL's opening is substantial proof that Thriftway's problems at that time cannot fairly be attributed exclusively (or materially) to NWL."

*Editor's Note: I want to thank John Stockdale, Jr. and **Valuation Case Digest** for sharing their court case summaries. For additional cases, I recommend that readers subscribe to **Valuation Case Digest**, which gives current case summaries in valuation and economic damages.*

Event Study Analysis

Continued from page 28

Additionally, the court credited the opinion of NWL's rebuttal expert, a credentialed business appraiser, that "road construction affecting access to a commercial venture can be expected to have adverse consequences for both sales and profits."

The court concluded that the lost profits analysis presented by Thriftway was speculative. It stated, "In terms of lost profits, Thriftway's damage calculation was inflated by an overly expansive and overly simplistic methodology."

It further noted that its expert's testimony ran afoul of De.R.Evid. 702 because it lacked a "basis in the knowledge and experience of the relevant discipline."

The court reasoned that the expert's reliance on Thriftway's owner's statements as to the cause of the decline in sales, the failure to exclude sales of products sold by Thriftway and not by NWL, and failure to exclude products not covered by the protective covenant made Thriftway's damage calculation speculative.

Therefore, the court determined that Thriftway could not recover any lost profits and awarded it nominal damages of $1 for NWL's violation of the protective covenant. ∞

Consulting Company's Lost Profits Speculative When Based on Potential Earnings of an At-Will Employee

In *Blase Industries Corporation v. Anorad Corporation,* No. 04-21015 (5th Cir. March 1, 2006), the U.S. Court of Appeals for the Fifth Circuit considered whether lost profits could be recovered for breach of a no-hire provision when the underlying employee was at-will. Blase provided computer consultants to companies, such as Anorad, that outsourced their computing requirements. The consulting contracts contained a no-hire provision prohibiting the outsourcing company from hiring any consultant sent to it for one year. Blase's employees were at-will employees. It sent a consultant to Anorad, who paid $2,000 per day for the employee. The employee was paid an annual salary of $99,000 by Blase. At some point, the employee became dissatisfied with Blase and sought permanent employment. He terminated his relationship with Blase. Thereafter, the former employee was hired by Anorad. Blase brought suit against Anorad for breach of the no-hire provision as it related to its former employee.

Blase sought lost profits from the breach. It estimated its lost profits at $341,000. It reached this figure by calculating the amount due at $2,000 per day over the remaining year time on the contract less $99,000 in salary expenses it paid to its employee at Anorad plus 10 percent for overhead. The district court granted summary judgment to Anorad based on its finding that the no-hire provision in the Blase-Anorad contract was unenforceable. Blase appealed.

The Fifth Circuit affirmed the grant of summary judgment in favor of Anorad, but on different grounds. It found that Blase's lost profits estimate was speculative. It started its analysis with the rule that the fact of lost profits must be reasonably certain but the amount of lost profits may contain a degree of speculation. Here, it found that the award of lost profits was based on the potential earnings of Blase's at-will employee. It noted, "The damages request relies on the assumption that … [the employee] would continue working for … [Blase], earning consulting fees for the year in question."

While it found no case law directly addressing this issue, it looked to employment law for "the general rule that at-will employees have no cause of action for termination and, therefore, cannot collect for future earnings."

Furthermore, the court found that Texas has statutorily limited the exceptions to this general rule. The Fifth Circuit reasoned: "The [Texas] court's unwillingness to expand these exceptions and the lack of a relevant statutory exception show that a Texas court would likely find that … [Blase] cannot base its damages calculation on the future earnings of an at-will employee."

Thus, the Fifth Circuit concluded that this was a two-way street: since an at-will employee cannot recover damages against its former employer for termination, the employer cannot base a lost profits calculation on an employee who has no contractual duty to remain in the employer's employ.

Therefore, the court found that the fact of damages was speculative when it was based on the assumption that the loss was generated by the potential earning of an at-will employee. ∞

Recovery of Lost Business Profits as Loss of Earning Capacity in Personal Injury Actions

Appraisers often have questions about about cases involving the quantification of damages in personal injury scenarios. Generally, personal injury actions with substantive forensic accounting issues don't arise with any degree of frequency. Therefore, it is noteworthy that three states issued opinions in this area and on the same topic: When and to what extent should a business's lost profits be considered in the computation of an injured party's lost earning capacity?

Tennessee addressed this issue with respect to a sole proprietor in *King v. General Motors Corp., No. M2004-00616-COA-R3-Cv* (Tenn. App. December 12, 2005). King suffered severe injuries in an automobile accident that was GM's fault. King began operating a limestone quarry on his property nine months before the accident. For the first three months, the operation was not profitable because labor costs were high. During the six months preceding the accident, King performed the labor himself and the quarry was profitable. However, there were no in-place contracts at the time of the accident. King provided expert testimony from an economist regarding the amount of his lost profits.

The Tennessee Court of Appeals held that lost business profits may be recovered as lost future earnings where the injured party is the sole operator of the business and his services are directly responsible for the business's profits. However, it found that the evidence in this case did not support the jury's lost profits award. It found the award speculative because the business had a history of losses, which had recently turned around, and the lack of in-place contracts called into question the continued viability of the business.

The Louisiana Court of Appeal, Third Circuit reached a similar conclusion in *Johnson v. Hamilton Medical Group, No. 05-204* (La. App. 3 Cir. February 1, 2006). Johnson was a sausage maker operating as a sole proprietor, who was injured during treatment he received from the defendant doctors. As a result of the injury, Johnson was unable to stand or sit for long periods and as a result his business declined. Johnson presented expert testimony from an economist regarding the quantum of his lost earning capacity, who calculated the future loss based on the cost to replace Johnson's services over his remaining actuarial life expectancy. Further, Johnson did not keep accurate business records or tax returns.

The court held that Johnson could not recover past lost profits as past lost earning capacity because he failed to provide any documentary evidence regarding the profits of his business. It credited the testimony of the doctors' rehabilitation counselor: "when someone is self-employed, you can't get an accurate indication of their earning abilities or what they're actually making, unless you go back and do a business analysis of all the other ancillary costs that are written off on your tax returns that's actually money in the person's pocket." Absent evidence of Johnson's business revenues and expenses, an award of past lost profits was inappropriate.

While King and Johnson discuss the evidentiary hurdles to the recovery of lost profits as a component of personal injury damages when dealing with a sole proprietor, the Indiana Court of Appeals considered whether a sole shareholder in an S corporation could similarly recover lost profits following an automobile accident. In *Bova v. Gary, No. 49A02-0505-CV-00385* (Ind. App. March 16, 2006), the appellate court held that the sole shareholder could recover because a sole shareholder in an S corporation is akin to a sole proprietor. It concluded, "We will entrust to the discretion of the trial court whether it is proper to introduce evidence of an S corporation's lost profits following an injury to its sole shareholder and virtual alter ego." In reaching this analysis, the court considered several factors: the number of shareholders, the pass-through nature of the S corporation, the reliance of the business upon the injured shareholder, and the degree to which the injured shareholder was personally responsible for the business's debt. It further concluded, "That he [the injured shareholder] continued to receive a salary is irrelevant when considered in light of the diminution in … [the corporation's] value and, consequently, the diminution of … [the injured shareholder's] personal net worth." Thus, the court permitted the recovery of lost profits of an S corporation where that S corporation functions more like a sole proprietorship than a C corporation.

King, Johnson and Bova together show that a sole proprietor and occasionally a sole shareholder in an S corporation may recover, as a component of lost earning capacity, lost business profits. However, any recovery of lost profits must not be speculative, and establishing the amount of the loss is subject to the same challenges arising in tort or contract situations.

Huber v. Commissioner
T.C. Memo. 2006-96, May 9, 2006

SUMMARY:
The Tax Court determined that sales of shares between family members in a closely held corporation were arm's-length transactions and supported the prices used for gift tax returns.

DETAILS:
Taxpayers Michael W. and Caroline P. Huber, Tabitha A. Huber, and Hans A. and Laurel D. Huber made various gifts of stock in J.M. Huber Corp. (Huber) between 1997 and 2000. Huber is a family-owned corporation with sales in excess of $500 million and approximately 250 shareholders. The shares of Huber are held by members of the Huber family, the Huber Foundation (a nonprofit charitable organization), and various independent nonprofit organizations, including universities. The prices used in the stock transactions were based on appraised values, including a consistently applied 50% discount for lack of marketability. The annual appraisals were used for all transactions, including intra-family sales, gifts to nonprofit organizations and corporate redemptions.

Taxpayers relied on this appraised value in making gifts, but the IRS challenged this value and whether the shareholder transactions were at arm's-length. The IRS appraisal expert concluded that the discount for lack of marketability should be 30 percent for 1997, 25 percent for 1998, 45 percent for 1999, and 30 percent for 2000. The Court did not deal with the IRS attack on the taxpayer appraisal, but focused instead on the arm's-length argument as the threshold issue.

One prong of the IRS attack on the arm's-length nature of the sales was that Huber did not offer shares for sale to the public and thus failed to obtain the optimum price. The Court rejected the notion that Huber must take itself public in order to sell its shares at a fair price, noting that, "Courts have long recognized the rights of shareholders in closely held companies to remain private…Further, respondent's assumption that offering a stock to the public would have garnered a higher price is purely hypothetical."

The IRS also argued that the bona fide business purpose of maintaining family control should be set aside if it serves as a device to "pass an interest to the natural objects of one's bounty or to convey that interest for less than full and adequate consideration." The Court dismissed this argument noting that the appraised value had been used for many instances such as charitable donations where a higher value would have been preferable. The Court said, "We reject respondent's suggestion that almost 250 shareholders would harmoniously accept an artificially low valuation of the Huber stock so that a few people who may or may not be related to them can pay less estate tax…We therefore conclude that the existence of close family relationships between parties of some of the 90 sales transactions in the record is neutralized by the fact that many of the transactions took place between parties that were hardly related or unrelated and who had fiduciary obligations to obtain the best price."

Another prong of the IRS attack was the lack of negotiations between buyers and sellers, suggesting that there was a lack of intent to realize the best price for the shares. The Court also rejected this, saying, "Respondent fails to cite any caselaw that holds that negotiation is a necessary element of an arm's-length transaction. In fact, the weight of authority is to the contrary."

The taxpayers completely prevailed in this case. ∞

Estate of Kelley v. Commissioner
T.C. Memo. 2005-235, October 11, 2005

SUMMARY:
The Tax Court allowed a 32 percent combined discount for lack of control and marketability for a decedent's 94.83 percent limited partnership interest in a family limited partnership owning only cash and certificates of deposit. The Court allowed the same discount for decedent's one third interest in the LLC that owned the 1 percent general partnership interest.

DETAILS:
Decedent and his daughter and son-in-law formed KLLP in 1999. Each contributed cash or certificates of deposit in exchange for limited partner interests. KLBP, LLC, owned one-third by decedent and two-thirds by his daughter and son-in-law, held the 1 percent general partner interest in KLLP.

Decedent died a few months after formation and there were no transfers of interests after the initial formation. The taxpayers claimed a 53.5 percent combined discount for lack of control and marketability while the IRS claimed a 25.2 percent combined discount.

Taxpayer Expert
The taxpayer appraiser gave an 80 percent weight to the net asset value and 20 percent to the income approach. He then applied a discount for lack of control based on general equity closed-end funds. It was his opinion that KLLP was most similar to the closed-end funds with price to net asset value discounts of 21.8 percent to 25.5 percent in the 4th quartile. The appraiser then reviewed the data from Partnership Profiles that showed the discount to net asset value for 18 publicly registered partnerships was 29 percent and the data for 100 publicly registered partnerships that had a 27 percent average discount. He concluded a 25 percent discount for lack of control was appropriate.

The expert based his discount for lack of marketability on restricted stock studies. The expert also discussed eight factors that provided barriers to marketability for limited partnership interests. Based on this analysis, the expert determined a 38 percent discount for lack of marketability was appropriate.

IRS Expert
The IRS expert relied solely on the net asset value. He used the arithmetic mean discount to net asset value for closed-end funds of 12 percent to determine his discount for lack of control. He believed using the mean removed the marketability element in the discounts or premiums.

The IRS expert relied on a study by Dr. Mukesh Bajaj and determined a 15 percent discount for lack of marketability was appropriate considering the low risk of the partnership's investment portfolio.

The Court
The Court relied solely on the net asset value, believing the income approach was not appropriate for a partnership holding only cash and certificates of deposit. For the discount for lack of control, the Tax Court believed that KLLP's lack of similarity to the closed-end funds required the use of more than just the 4th quartile. The Court also believed that the Partnership Profiles data overstates the discount because they contain some element of marketability. The Court found neither expert particularly persuasive, but determined a 12 percent discount for lack of control was appropriate.

For the discount for lack of marketability, the Court believed that there are fundamental differences between operating companies used in the discount studies and an entity holding easily valued and liquid interests like cash and certificates of deposit. The Court was also troubled that the taxpayer expert did not analyze the data from the studies and rejected the taxpayer expert's conclusion.

The Court also rejected the IRS expert's conclusion, but did conclude that the Bajaj study was an appropriate tool for determining discounts. The Court did not believe the expert properly applied the study. The Bajaj study divided the discount into three groups with the middle group having a discount of 20.36 percent. The Court relied on *McCord v. Commissioner, 120 T.C. No. 13,* which used this middle group, rounded to 20 percent. The Court further cited the analysis in *Lappo v. Commissioner, T.C. Memo 2003-258,* in which an additional 3 percent marketability discount was allowed because of characteristics specific to the partnership and added the same 3 percent, resulting in a total discount for lack of marketability of 23 percent.

The Court allowed the same discounts for the decedent's 33.33 percent interest in KLBP, the LLC that owned a one percent general partner interest in KLLP. The discounts were applied directly to the one percent general partner interest without allocation between the limited partnership and LLC ownership interests. ☙

Albert Strangi et. al v. Commissioner, No. 03-60992
U. S. Court of Appeals for the Fifth Circuit
July 15, 2005

SUMMARY:

The United States Court of Appeals for the Fifth Circuit has upheld a US Tax Court decision that the full amount of the assets transferred to a family limited partnership must be included in decedent's estate under §2036(a).

DETAILS:

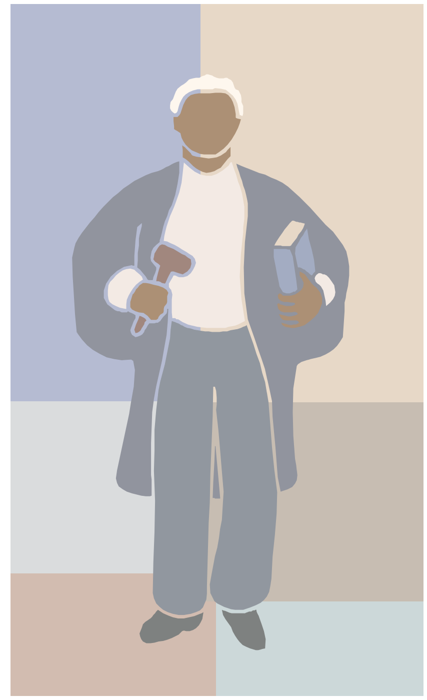
Shortly before his death in 1994, Mr. Strangi transferred 98% of his assets to a family limited partnership (SFLP). In 2000, a sharply divided Tax Court held: (1) SFLP was valid under State law and would be recognized for estate tax purposes, (2) I.R.C. §2703(a) did not apply to the partnership agreement, and (3) the transfer of assets to the partnership was not a taxable gift. (Strangi I)

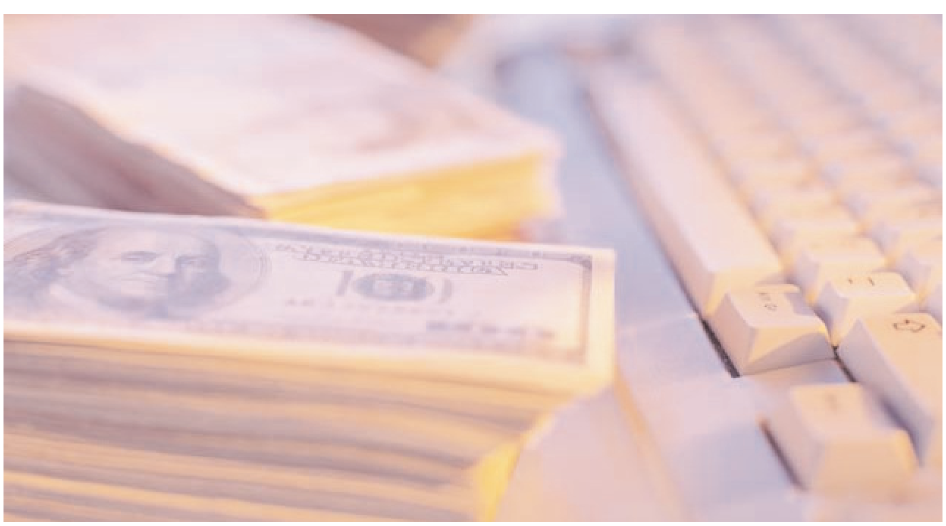
The IRS appealed the decision and the Fifth Circuit considered the IRS's request for leave to amend in order to add a §2036 claim. Under §2036, the estate would be required to include the assets transferred by Mr. Strangi to SFLP rather than just his partnership interest in SFLP. The Fifth Circuit disagreed with the Tax Court's denial of the IRS leave to amend and reversed the Tax Court on that single issue.

Upon remand, the Tax Court determined that the transfers to SFLP met the tests under both §2036 (a)(1) and §2036(a)(2) and ruled that the full amount of the assets transferred must be included in decedent's estate. (Strangi II) The Estate appealed this ruling to the Fifth Circuit, which affirmed the Tax Court decision.

The Fifth Circuit determined that there was no clear error in the Tax Court's finding under §2036(a)(1) that there was an implicit agreement with the Strangi children that Mr. Strangi would retain enjoyment of his property after the transfer to SFLP. For example, Mr. Strangi lived in a house he transferred to the partnership, but the partnership did not receive rent until more than two years after he died. In addition, Mr. Strangi held few assets outside of SFLP and relied on partnership distributions to pay a number of personal expenses as well as many post death expenses.

The estate also argued that the "bona fide sale for an adequate and full consideration" exception should apply to the transfer of assets to SFLP.





The Tax Court agreed that there was "full and adequate consideration" but determined there was no "bona fide sale." The Fifth Circuit adopted the position that a sale is bona fide if, "as an objective matter, it serves a 'substantial business (or) other non-tax' purpose." In Tax Court, the estate advanced five non-tax rationales for Mr. Strangi's transfer of assets to SFLP. The Fifth Circuit carefully noted that they found no "clear error" by the Tax Court in rejecting these rationales, but not whether they would have reached the same conclusion.

CONCLUSION:

This is certainly a clear win for the IRS in the Fifth Circuit. Unfortunately for estate planners, the Fifth Circuit opinion offered no guidance on the decision it might have reached on the bona fide sale test had it been presented the same facts as the Tax Court. ꩜

Question: Can you tell me who the top three customers of the company are?
Answer: I can't recall.

Question: How many employees does the company have?
Answer. I'm not sure, a lot.

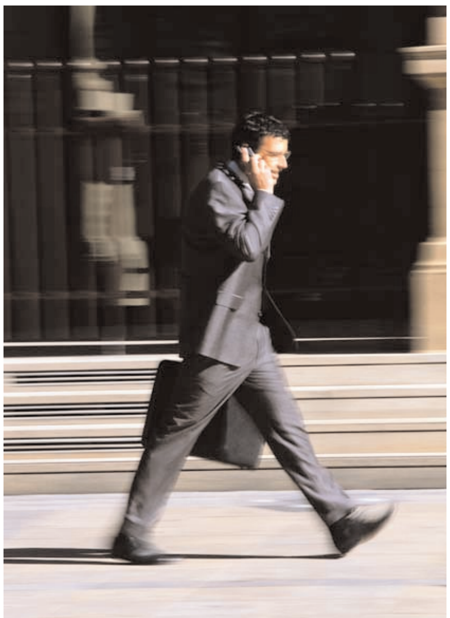
Question: Do you know why the company's profits went down from 2004 to 2005?
Answer: They weren't doing as well.

Question: Well, Mr. Dude, that's not very helpful. Specifically, tell me why they weren't doing as well and why specifically their profits went down that year.
Answer: Well, it was several things.

Question: Please explain exactly what the most important factors were.
Answer: I can't recall specifically.

Question: Do you agree that federal regulation is a consideration in this industry?
Answer: Yes.

Question: Are you aware of any new federal regulations or legislation concerning this industry over the past three years?
Answer: No.



Question: Did you research to find out whether there were any federal regulations or legislation affecting this industry in the past three years?
Answer: No.

Question: So, if I told you that there was new legislation or regulations concerning this industry, could that possibly affect your value?
Answer: I don't know, maybe. It depends on what they are.

Question: But you don't know what they are, do you?
Answer: No.

Question: Do you know who the company's top three competitors are?
Answer: Well, I assumed there were no publicly traded companies.

Question: The question is, do you know the top three competitors of the company?
Answer: Well, I know that there's one of them that's in Florida, but I can't recall its name.

Question: Can you name any of the other competitors or describe these competitors or tell us anything about the top three competitors?
Answer: No.

Question: I show you here a study prepared by Val Bigshot titled "Problems with the build up method for discount rates." Don't you agree this study undermines your conclusions of value?
Reply A: Yes.
Reply B: No.
Reply C: This is an 8-page document that I have not previously reviewed. Before I can answer any questions about this study I need to carefully review it. I should be able to do so in approximately one hour. Would you like me to start my review now?

Question: How much are you being paid for your testimony today?
Reply A: $300 per hour.
Reply B: Not nearly enough.
Reply C: I am being paid $300 per hour for my time, not my testimony.

Question: $300 per hour! That's outrageous. How do you justify $300 per hour?
Reply A: It's the going rate.
Reply B: I'm worth it. I don't need to justify it to you or anyone else.
Reply C: My hourly rate is based on my education, training, and 25 years of experience.

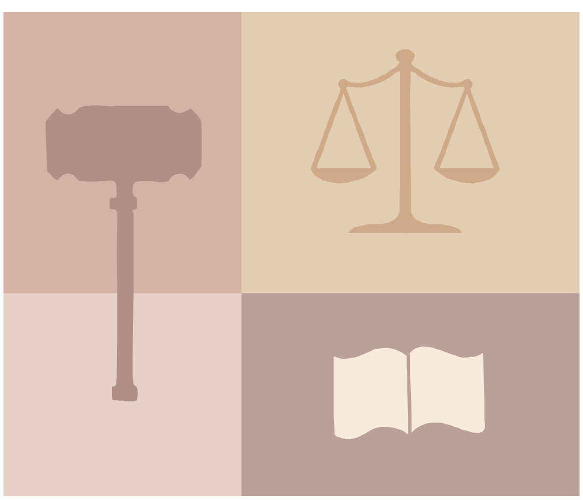
Question: Your fees are twice my expert's fees. Are you a hired gun for money?
Reply A: No.

Reply B: You get what you pay for.
Reply C: My fees are fair and reflect the detailed level of work I performed. Given the level of work presented by your expert, I am surprised his fee is so high.

Question: You are a professional expert witness, correct?
Reply A: What do you mean by professional?
Reply B: This is no place for amateurs.
Reply C: I am a financial analyst who also prepares business valuations for all reasons including litigation matters.

Question: Will you agree to reply to my questions with only a "yes," "no," or "I cannot reply with a yes or no"?
Reply A: Yes.
Reply B: No.
Reply C: I cannot reply to that with a yes or no.
Reply D: Because I do not want my replies to be used to mislead, I cannot agree to that.

Question: How do you promote your expert witness practice?
Reply A: I dont have to. They are banging down the door to hire me.
Reply B: By advertising, my website, speaking and writing.
Reply C: I do not have an expert witness practice to promote.
Reply D: I am a financial expert who is sometimes asked to be an expert witness.



Question: Did you help your attorney prepare her case?
Reply A: Well, I could have helped you. Too bad, given the current state of your case.
Reply B: Yes. She asked me and I helped her.
Reply C: Ms. Lawyer is not my attorney.
Reply D: Ms. Lawyer is not my attorney; she is the plaintiff's attorney. No, I didn't help her prepare her case. Like you, she is quite capable of doing that on her own. I simply provided her with my honest unbiased appraisal and with the technical components of that appraisal. I also provided you with the same appraisal and I am now explaining the same technical components to you, the judge and the jury.

Question: During your direct examination, you replied to the questions asked and cooperated with counsel. Will you give me the same cooperation?
Reply A: You have got to be kidding.
Reply B: I would be pleased to.
Reply C: You will be cross-examining me, counsel, in an attempt to discredit me and my testimony. No, I will not cooperate with that.
Reply D: I will show you the same cooperation and courtesy as you show me.
Reply E: I am here to tell the whole truth— the good, the bad, the ugly. If you allow me to tell the whole truth as my client's counsel did, you will find me to be very cooperative. If, on the other hand, replying to a question in a way you want would mislead and distort, I will be obligated to point this out to the judge or jury.

Question: Do you agree with the following statement? (Note: taken from old article written by expert; expert used the build up model in his current valuation) "The Build Up Model should not be used to calculate a discount rate."

Reply A: Where did you get that?
Reply B: No, I do not.
Reply C: Who said that?
Reply D: It depends on the specific facts and circumstances.
Reply E: You have taken that sentence out of context. I would like to see the entire article so I can reply to your question in a way that will not be misleading.
Reply F: I agreed with that when I wrote it 10 years ago. However, since then, the build up model has become acceptable. I try to continually keep up in my industry so, with newer information, I now believe the build up model is a valid method. Furthermore, it has been accepted by my peers in the valuation industry for many years.

Question: Can two independent and qualified experts disagree as to the value of a company?
Reply A: Yes.
Reply B: No, they should arrive at the same value.
Reply C: That depends on how you define disagree.
Reply D: I believe that two independent and qualified experts should arrive at a similar value, assuming they relied upon the same information and did not commit errors or omit information. As I testified previously, your expert erred in several areas that caused her value to be so different from mine. Would you like me to elaborate on those errors?

SEAK DEPOSITION PREPARATION OUTLINE

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TYPE OF DEPOSITION
A. Preservation of evidence
B. Discovery

HOUSEKEEPING DETAILS
A. Manner of dress
B. Where and when to report
C. Parking availability
D. Estimated time of deposition
E. Who will be present for deposition

COMPENSATION
A. Obtain fee in advance
B. Charge for preparation, travel, and out-of-pocket expenses
C. Charge for last-minute cancellations

STIPULATIONS
A. Do not agree to waive reading and signing

YOUR PREPARATION
A. Locate all records and tests you have reviewed
B. Organize your file for easy reference
C. Review your opinion and case weaknesses/strengths
D. Discuss case with client attorney
E. Try to get opposing counsel's style, techniques and theory of the case
F. Think about the difficult questions and issues
G. Know the timeline in the case

PREPARATION WITH COUNSEL
A. Types of questions opposing counsel will ask
B. Questions retaining counsel will ask
C. Review legal standards and "magic words"
D. Look at contents of your file
E. Discuss what to bring to deposition
F. Update on status of litigation
G. Review of opinions

IN DISCOVERY DEPOSITION COUNSEL'S GOALS ARE TO
A. Learn opinions
B. Explore qualifications
C. Lock down the expert
D. Evaluate credibility
E. Probe for bias
F. Learn factual assumptions
G. Gather as much information as possible
H. Use the expert to bolster counsel's case
I. Intimidate the expert
J. Learn as much as possible about the case

SUBPOENAS
A. Have you received a subpoena duces tecum?
B. Have you complied with the subpoena?

CURRICULUM VITAE
A. Make sure it is accurate and up-to-date
B. Bring extra copies to deposition
C. Any exaggerations?

INCONSISTENT PRIOR STATEMENTS
A. Interrogatories
B. Prior written statements and reports
C. Prior cases

INVOLVEMENT IN CASE
A. When were you first contacted concerning this case?
B. By whom were you contacted?
C. How were you contacted: Phone, letter, e-mail, other?
D. When did you accept the case?

RELATIONSHIP WITH COUNSEL
A. What is your personal/financial relationship with counsel who has retained you in this case?

WORK YOU HAVE DONE IN THIS CASE
A. Records and documents reviewed: Which ones and when?
B. Examination: What was done and when was it done?
C. Testing: What was done, when was it done, and what were the results?
D. Is all of this work reflected on your bills and invoices?
E. What additional work do you anticipate doing prior to the trial?

EDUCATIONAL BACKGROUND
A. What schools have you attended?
B. What were your major areas of study?
C. What degrees did you obtain?
D. What are the dates for your attendance and degrees?
E. What additional training courses have you attended?
F. What continuing education courses have you attended in the past ten years?
G. Have you been the subject of any disciplinary actions?
H. Have your licenses ever been suspended or revoked?
I. What were your grades?
J. What did you do between any gaps in your education?

OPINIONS
A. The opinions you will be testifying to
B. The facts and assumptions upon which the opinions are based
C. The methodology employed in deriving the opinion
D. When the opinion was first formed
E. The documents you used in forming the opinion
F. The degree of flexibility in the opinion
G. How the proposed opinion compares to answers previously given during discovery

ORGANIZATIONS
A. What professional organizations and societies are you a member of?
B. What is your status in these organization(s)?
C. Have you ever paid a fee to obtain additional credentials?

FORENSIC INCOME
A. Percentage of income from forensic work
B. Percentage of time testifying for plaintiffs
C. Percentage of time testifying for defendants

PUBLICATIONS
A. State all of the articles, chapters, books, reviews, abstracts, and other writings that you have had published
B. When and where were these published?
C. Specify if any of your writings have not been accepted for publication

DATES
Make sure you know the key dates:
A. When you were first contacted by counsel
B. When you were retained as an expert
C. When you received the records
D. From whom they were received

SEAK DEPOSITION PREPARATION OUTLINE

www.seak.com

E. When you formed your opinion(s) in the case
F. The date of the event in question
G. The date(s) key tests were performed

FEES

A. Hourly rate
B. Rate for deposition and trial testimony
C. Amount billed/paid to date
D. Future billing

WHAT MATERIALS OR RECORDS WERE YOU PROVIDED? BY WHOM? WHEN WERE THEY PROVIDED?

A. Correspondence
B. Reports
C. Messages
D. Notes
E. Computer disks/e-mails/files
F. Police reports
G. Investigative reports
H. Medical and hospital records
I. Literature
J. Tables
K. Standards
L. Contracts
M. Photographs
N. Videotapes
O. Research
P. Test results
Q. Other materials

VIDEOTAPE DEPOSITIONS

A. Prepare with counsel and practice before a videotape camera
B. Dress conservatively
C. Look directly at the camera when testifying
D. Avoid long pauses that may make you look evasive or uninformed
E. When handling exhibits, make sure you hold them so that they can be appreciated by the viewers
F. Avoid eating, smoking, drinking, chewing gum, or chewing on pens or pencils
G. Turn off pagers, cell phones, and beepers
H. Avoid making unnecessary and distracting noise by rustling papers, touching the microphone, or moving furniture
I. Avoid being goaded into flashes of anger, arrogance, and combativeness
J. Watch out for your nonverbal behavior and body language
K. Don't let counsel lead your eyes away from the camera

GENERAL ADVICE

A. Tell the truth
B. Act naturally
C. Don't be arrogant
D. Avoid slang
E. Be careful of what you highlight or write down
F. Don't argue with counsel
G. Don't elaborate
H. Don't estimate
I. Don't exaggerate
J. Don't guess
K. Don't interrupt the question
L. Don't lose your temper
M. Don't speculate
N. Leave yourself an out
O. Listen carefully to the questions
P. Make sure you know your role in the case
Q. Don't joke
R. Pause before answering
S. Read the documents before you testify about them
T. Say you don't know if you don't know
U. Say you don't remember if you don't remember
V. Stay within your area of expertise
W.Take breaks when needed
X. Avoid absolute and hedge words

PLEADINGS

A. Complaint
B. Answer
C. Interrogatories
D. Depositions
E. Motions
F. Motions to compel
G. Others

AUTHORITATIVE TEXTS

A. Know what is "authoritative"
B. Do not commit unless you see the text

BREAKS

A. Ask for breaks when needed
B. Don't consult with retaining counsel during breaks

ANSWERING DEPOSITION QUESTIONS

A. Tell the truth
B. Answer only what you are asked and do not volunteer information
C. Pause before answering
D. Actively listen to the entire question and do not interrupt
E. "I don't know" may be an appropriate response
F. Don't exaggerate, speculate, or guess
G. Keep your cool
H. Do not argue with counsel or get involved in the lawyers' arguments
I. Don't fall for the "silence" gambit
J. Avoid jokes, sarcasm, and inappropriate remarks
K. Don't ramble
L. Avoid absolute words
M. Be flexible and be prepared to concede some points
N. Avoid slang
O. Don't fall for the "bumble and fumble" gambit
P. Do not act like a jerk
Q. If confused, ask for the question to be repeated
R. Ask to see documents, reports, and statements before answering questions about them
S. Take adequate time to review any "new" documents, reports, etc.
T. Prepare thoroughly

DAUBERT ISSUES

A. Has the theory or technique used been tested?
B. Has the theory or technique been subjected to peer review and publication?
C. What is the known or potential rate of error of the method used?
D. What is the degree of the method's acceptance within the relevant scientific community?

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GUIDE TO ABBREVIATIONS

ABV- Accredited in Business Valuation with the American Institute of Certified Public Accountants (AICPA)
ASA- Accredited Senior Appraiser with the American Society of Appraisers (ASA)
BV- business valuation
CBA- Certified Business Appraiser with the Institute of Business Appraisers (IBA)
CDFA- Certified Divorce Financial Analyst with the Institute for Divorce Financial Analysts
CFA- Chartered Financial Analyst with the CFA Institute
CFE- Certified Fraud Examiner with the Assn. of Certified Fraud Examiners
CFFA- Certified Forensic Financial Analyst with NACVA
CFP- Certified Financial Planner with the Certified Financial Planner Board of Standards, Inc.
CIRA- Certified Insolvency and Restructuring Advisor
CM&A- Certified in Mergers & Acquisition by the Alliance of Merger & Acquisition Advisors
CM&AA- Certified Merger & Acquisition Advisor by the Alliance of Merger & Acquisition Advisors
CPA- Cetified Public Accountant
CVA- Certified Valuation Analyst with the National Association of Certified Valuation Analysts (NACVA)
DABFA- Diplomate of the American Board of Forensic Accounting
FASA- Fellow of the American Society of Appraisers
JD- juris doctor
MBA- Masters of Business Administration
MCBA- Master Certified Business Appraiser with the IBA
MST- Masters of Science in Taxation
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