

# Litigation &

V a l u a t i o n

REPORT

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## Going above and beyond

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# Going above and beyond

Accurate valuations consider more than financial statements

**M**anagement interviews and site visits are an indispensable part of the valuation process. Call it “kicking the tires” or “looking under the hood.” But whichever metaphor you prefer, to get an accurate picture of a company’s financial outlook, it’s critical to consider more than just the financial statements.

## Don’t court disaster

Looking beyond the numbers is especially important in a litigation context. As courts become more sophisticated about valuation techniques and theory, they’re scrutinizing valuation reports and demanding that valuation experts back up their assumptions. Experts who neglect to interview management or tour a company’s facilities — or who aren’t given the access they need — may have little credibility with a judge or jury.

For example, in *In re Robert E. Mahoney, Jr., Debtor*, the issue before the bankruptcy court was the appropriate valuation of some stock shares. The state court’s judgment had already obligated the debtor to pay the shares’ fair market value to the claimant. But the state court didn’t determine what that value was.

The bankruptcy court rejected the testimony of the claimant’s valuation expert, finding several flaws in his analysis. The court was particularly critical of the expert’s earnings projections, which he prepared without consulting the company’s management or employees.

## Nail the interview

Interviewing management and other employees is a vital part of the valuation process. A company’s financial statements provide a snapshot of its recent financial history and its current condition. But valuation is also about the future, and the financial statements tell only part of the story.

Fair market value typically is defined as “the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.” Regardless of how well a company has performed in the past, the price a buyer is willing to pay for it depends on the probability that its future projected earnings will be achieved.

If a company has audited financial statements, they may reveal some of that risk. For example, the footnotes may

## The impact of products and technology on business value

Products and technology can significantly affect a company’s value. The valuator needs to investigate how the business manufactures, markets and distributes its products. He or she should ask questions such as:

- Where are the products in their life cycle?
- Does the company have new products in the development pipeline?
- Is the company vulnerable to foreign competition?
- What is the useful life of the company’s equipment?
- Is new technology being developed that will render it obsolete?
- Does the company have sufficient plant capacity to handle future growth?

These questions are particularly important when a company has been grooming itself for sale. It’s not unusual for owners to spruce up their earnings by cutting spending on research and development, marketing, and capital improvements. But this type of short-term fix may increase the company’s risk over the long term.



reveal pending litigation or refer to a large pension or deferred compensation obligation looming on the horizon. But many business risks can be detected only through effective valuation interviews. Here's a sampling of the areas your valuation expert should probe:

**Management and personnel.** The quality of a company's top management and other employees can make the difference between success and failure. And the more a company relies on one person or a small group of people, the greater its risk in the event one of them dies or leaves the company (in other words, thin management).

Interviews allow the valuator to look behind formal titles and organizational charts to find out how things are really done. In a small business, for example, the owner may make all major decisions, despite the apparent authority of the management team. And key people are not limited to the CEO. The CFO may be essential to the company's ability to obtain financing. In addition, the loss of a salesperson that has a close personal relationship with the company's biggest customer can be devastating.

A valuator also needs to consider continuity. The risk associated with a dominant owner, for example, can be tempered by the existence of a strong successor and a solid management transition plan.

**Competitors.** How do the company's products or services stack up against the competition? What is its market share? Does the company hold patents or other rights that give it a competitive advantage? If it's a distributor, does it have exclusive distribution rights to strong-brand-name products? Are there barriers to entry, such

as large capital requirements, that limit competition in the industry?

The valuator should evaluate the company's competitive position and inquire about its strategies for reducing competitive risk going forward.

**Customers and suppliers.** The valuator should explore the length, type and stability of the company's customer and supplier relationships to get a feel for the risk involved.

Does the business rely on repeat customers or is it transactional in nature (a construction company, for example)? How much of the company's business is concentrated in one or a few customers? Are customer relationships driven by personal relationships with the owner or a key salesperson? Does the business depend on referrals? If so, what factors influence the likelihood that these referrals will continue?

Are there any long-term contracts that bind customers to the company? This can increase or decrease risk depending on the contract terms and price volatility in the marketplace.

*Many business risks can be detected only through effective valuation interviews.*

Similar concerns apply to supplier relationships. A company that relies heavily on one supplier risks serious damage if the relationship is terminated. Like contracts with customers, supply contracts can be an advantage or a disadvantage, depending on their terms and the nature of the market.

#### **Dig beneath the surface**

These are just a few of the ways a valuator can use management interviews to develop a more realistic picture of a company's financial risk. The additional time investment will pay off in the form of a more accurate and credible valuation report. □

# The backdating game

## Stock option scandal raises litigation issues

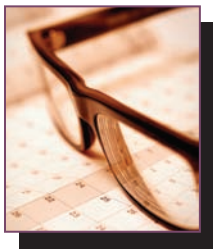
In the spring of 2006, the *Wall Street Journal* published a front-page article challenging stock option practices at some of the country's largest corporations. The investigation was prompted by a 2005 study by University of Iowa professor Erik Lie, who discovered a suspicious pattern: Some corporations were routinely granting options when stock prices were at their lowest.

The *Journal's* revelations quickly escalated into a full-fledged scandal. Today, the Securities and Exchange Commission (SEC) is investigating more than 100 companies for allegedly backdating stock options — and that number continues to grow.

Although it is large public corporations that are under scrutiny, closely held companies are not beyond the scandal's grasp.

### An imperfect match

Historically, companies have granted stock options “at the money,” which means the exercise price is equal to the stock's fair market value on the grant date. “At-the-money” grants offer certain tax and financial advantages over “in-the-money” — more commonly known as “discounted” — stock options.



At-the-money options, for example, are exempt from current taxation, while discounted options create immediate taxable gains. And under accounting rules that applied before 2006, companies were not required to report any compensation expense on their financial statements in connection with grants of at-the-money options. Discounted options, on the other hand, had an immediate impact on earnings.

Backdating is a company's way of taking advantage of 20/20 hindsight. Options have value only if the underlying stock's price rises, allowing executives to purchase it at a discount. Companies engaged in backdating wait

for stock prices to go up and then grant executives options that are dated earlier, when prices were lower.

Executives enjoy instant profits. And because the options are dated as if they had been granted at the money, the company and its executives avoid any negative tax or financial reporting consequences.

### Dates gone wrong

Companies caught backdating can quickly find themselves stuck in a litigation quagmire. Here are just a few of the issues they may face:

**Accounting problems.** Contrary to popular belief, stock option backdating isn't necessarily illegal and doesn't always violate accounting standards. The real problem is backdating without:

- Disclosing the practice to investors,
- Recording the appropriate compensation expense in the company's financial statements, and
- Reporting the transaction properly for tax purposes.

Of course, following the rules eliminates most of the benefits of backdating, so it's no surprise that some companies tend to keep it under wraps.

Most backdating-related accounting controversies involve options granted before 2006. Under accounting rules that, for most companies, took effect last year, employee stock options must be expensed at fair value, which generally eliminates the accounting advantages of backdating.

But for options granted earlier, companies were not required to recognize compensation expense for at-the-money options, so manipulating grant dates has had a big impact.

Improper backdating may result in enormous restatements of earnings. And public companies guilty of backdating may violate federal securities disclosure and reporting requirements, exposing themselves to regulatory

or criminal investigations as well as securities fraud litigation. Public company CEOs and CFOs may also find themselves liable under the Sarbanes-Oxley Act for falsely certifying the company's financial statements.

Last September, the SEC's chief accountant issued a letter providing guidance on the accounting impact of some option-granting practices. The letter recognizes, for example, that legitimate discrepancies may exist between the date an option is granted and the date it is finalized as a result of "unimportant delays in the completion of administrative procedures to document the grant that did not involve misrepresentation of the option granting actions."

To avoid backdating problems, companies in this situation should be sure that their option-granting practices are consistent and well documented.

**Tax issues.** As noted above, at-the-money stock options are not currently taxable. Yet if they're found to be disguised discounted options, the consequences for both the executive and the company can be harsh. The executive will be liable for income taxes on the gain, plus interest and penalties, and the company will be liable for failing to withhold income and payroll taxes.

Backdating may also raise executive compensation concerns. Companies are permitted to deduct up to \$1 million in compensation paid to top executives, but "performance-based compensation," such as at-the-money stock options, doesn't count toward that limit.

If the IRS determines that backdated options were in fact discounted options that didn't qualify as performance-based compensation, the company may lose deductions it claimed on previous tax returns, resulting in back taxes, penalties and interest.

**Shareholder litigation.** Both public and private companies implicated in a backdating scandal may find themselves on the receiving end of shareholder lawsuits. Shareholders may allege that the company's directors and officers breached their fiduciary duties by backdating stock options in order to enrich top management.

#### The morning after

The first step in proving or disproving backdating is to conduct a forensic accounting review of a company's stock option policies, practices and documentation to test for compliance with applicable accounting, tax and disclosure standards. Often, the only evidence of backdating is circumstantial, so an accounting expert looks for patterns showing that options were routinely granted when stock prices were at their lowest.

Backdating charges have forced executives and board members to resign and prompted a flurry of litigation on issues ranging from tax and accounting irregularities to breach of fiduciary duty to securities fraud.

It's important to understand the uses — and potential abuses — of stock options to avoid these potential problems. □

## USPAP revisions clarify valuator responsibilities

The *Uniform Standards of Professional Appraisal Practice* (USPAP), published by the Washington, D.C.-based Appraisal Foundation, are considered the generally accepted standards for professional appraisal practice in North America. A growing number of professional appraisal associations, government agencies and others require valuers to comply with USPAP.

In a litigation context, courts view USPAP compliance as an important gauge of a valuation expert's credibility. For example, in *Kohler v. Commissioner*, the Tax Court rejected the testimony of the IRS's valuation expert.

Among other criticisms, the court noted that the expert "did not provide the customary USPAP certification, which assures readers that the appraiser has no bias

regarding the parties, no other persons besides those listed provided professional assistance, and that the conclusions in the report were developed in conformity with USPAP.”

### Departing from previous versions

The latest edition of USPAP, which took effect July 1, 2006, contains several substantial revisions. One of the most significant changes was to eliminate the “departure rule” and introduce a new “scope-of-work” rule. Here’s a comparison of the two:

**Departure rule.** Previously under this rule, valuation activities were divided into “binding requirements,” which were mandatory, and “specific requirements,” which were specific to a particular assignment. A valuator and client could agree to depart from a specific requirement — as long as the results were credible — but the valuation would have then been labeled a “limited appraisal” rather than a “complete appraisal.”

In drafting the 2006 revisions, the Appraisal Foundation’s Appraisal Standards Board (ASB) recognized that the departure rule was confusing and often led clients to erroneously believe that complete appraisals were inherently more reliable than limited appraisals. The problem was that, under the departure rule, valutors described only what they *did not* do — that is, they stated that they departed from a specific

requirement. They did not describe the actual steps they took to arrive at a valuation result.

**Scope-of-work rule.** The new scope-of-work rule shifts the focus away from the negative (what the valuator didn’t do) to the positive: what the valuator *did* to arrive at a credible valuation result. Now, for each valuation assignment, an appraiser must:

1. Identify the problem to be solved,
2. Determine and perform the scope of work necessary to develop credible assignment results, and
3. Disclose the scope of work in the report.

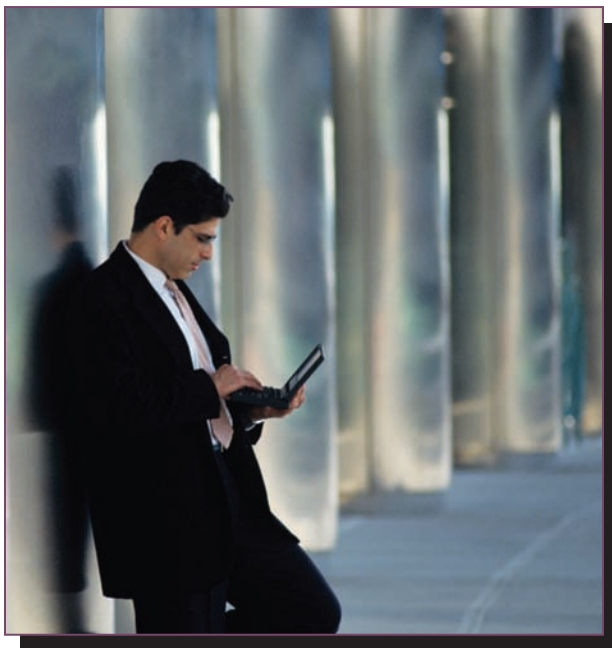
The ASB’s comments note that “scope of work” includes, but is not limited to:

- The extent to which the appraiser identifies the property,
- The extent to which the appraiser inspects tangible property,
- The type and extent of data the appraiser researched, and
- The type and extent of analyses the appraiser applied to arrive at opinions or conclusions.

The revised USPAP contains many other changes that are beyond the scope of this article. But the overarching theme is credibility. The 2006 edition even includes “credible” as a defined term — “worthy of belief” — with the added explanation that “credible assignment results require support, by relevant evidence and logic, to the degree necessary for the intended use.”

### Increasing flexibility

Ultimately, the new standards provide valutors with a great deal of flexibility to tailor a valuation to the client’s specific needs, without being pigeonholed by the “complete” and “limited” labels. But with this flexibility comes added responsibility — not only to develop a valuation that produces credible results, but also to demonstrate that credibility to a judge, jury or other user of the valuation report. □



## New guidance for measuring fair value

Last September, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, to provide guidance on measuring fair value. The new standard applies to financial statements issued for fiscal years beginning after Nov. 15, 2007, and for interim periods within those fiscal years.

### A revised definition

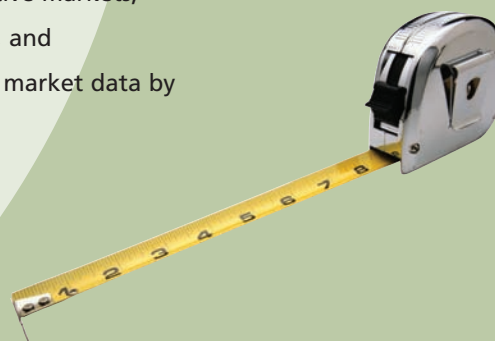
Traditionally, organizations have reported assets and liabilities at their historical cost. But, recently, FASB has required certain assets, such as derivatives and employee stock options, to be reported at fair value. SFAS No. 157 doesn't change the rules about which assets are measured at fair value. But it does establish uniform guidelines to meet the need for fair value measurement consistency and comparability — as well as expanding related disclosure requirements.

The statement defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” According to FASB, the underlying measurement objective is “generally consistent with similar definitions of fair market value for valuation purposes.” It emphasizes that fair value is a market-based measurement rather than a specific entity measurement.

### The fair value hierarchy

SFAS No. 157 shifts emphasis to market-based methods to promote more accurate and consistent valuations. The statement establishes the following fair value hierarchy:

1. Top priority is given to Level 1 inputs, which are quoted prices in active markets for identical assets or liabilities that the reporting entity is able to access at the measurement date.
2. If Level 1 inputs aren't available, the valuator proceeds to Level 2 inputs, which include:
  - Quoted prices for similar assets or liabilities in active markets,
  - Quoted prices for identical or similar assets or liabilities in inactive markets,
  - Other observable inputs, such as interest rates and yield curves, and
  - Inputs derived principally from, or corroborated by, observable market data by correlation or other means.
3. A valuator should give the lowest priority to Level 3 inputs, which are unobservable inputs, such as the reporting entity's own data. But SFAS No. 157 stresses that these internal inputs should reflect the assumptions market participants would use in pricing the asset or liability.



### A significant impact

When SFAS No. 157 takes effect, it will have a significant impact on how valutors measure fair value as well as on an organization's financial reports.