

valuation & litigation briefing

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Liquid measures

Using pre-IPO studies to quantify marketability discounts

When valuing an interest in a closely held business, an appraiser typically applies a discount for lack of marketability (DLOM). The discount can be substantial, and for years valuers and researchers have been looking for new ways to support and quantify it.

Today one of the most common methods is to use pre-initial public offering (IPO) studies. These studies compare companies' stock prices in private transactions with the prices eventually received in IPOs. In theory, the difference between the two represents the DLOM. Pre-IPO studies provide an excellent starting point for calculating the DLOM, but they shouldn't be relied upon exclusively.

Defining marketability

The *International Glossary of Business Valuation Terms* defines "marketability" as "the ability to quickly convert property to cash at minimal cost." The American Society of Appraisers defines the term as "the capability

and ease of transfer or salability of an asset, business, business ownership interest or security."

It's obvious that a private company's stock is less liquid, and therefore less valuable, than freely traded stock in a comparable public company. But how do you measure the appropriate valuation discount?

Restricted stock studies

Early attempts to quantify the DLOM relied on restricted stock studies, which compare trading prices of a public company's stock with prices in private transactions involving unregistered or restricted shares of the same company.

One drawback to restricted stock studies is that eventually the restrictions will be lifted, allowing the stock to be freely traded on the open market. So, by definition, restricted stock is more liquid than private company stock. In addition, Securities and Exchange Commission (SEC) rule changes in recent years have enhanced the liquidity of restricted stocks.

Other important DLOM factors

Average discounts for lack of marketability (DLOMs) derived from pre-IPO and other empirical studies provide a great starting point, but a valuator also adjusts the discount based on company-specific factors, such as:

- The company's dividend-paying capacity,
- The amount, growth and stability of the company's revenues and earnings,
- The company's history, industry and product risk,
- The likelihood of an IPO in the near future,
- The redemption policy and the holding period,
- Stock restrictions,
- Control, and
- The company's management.

Generally, stock in a company with a history of paying higher dividends is more attractive to prospective buyers and, therefore, more marketable, resulting in a lower DLOM. Similarly, stock in companies with higher and more stable revenues, earnings and growth, as well as lower risk, tends to be more marketable. And, of course, if stock is expected to become more liquid as a result of an anticipated IPO, the DLOM will be lower.



In 1990, for example, the SEC eliminated the requirement that transactions involving restricted stock be registered. And, in 1997, the SEC cut the required holding period for restricted stocks from two years to one. As a result, more recent restricted stock studies reflect lower DLOMs than pre-1990 studies.

Pre-IPO studies

Pre-IPO studies compare stock prices at the time of an IPO with prices of the same stock in private, arm's-length transactions before the company went public. Proponents of this method feel that these studies offer a more accurate picture of the DLOM than restricted stock studies because the pre-IPO transactions involved truly private stock with limited liquidity.

Critics point out that, in many pre-IPO sales, the buyers and sellers are aware of the possibility that an IPO may

increase the marketability of their shares. They also argue that some pre-IPO studies include transactions that reflect compensation to insiders, who may receive their shares at discounted prices. And some commentators suggest that pre-IPO studies reflect discounts for factors other than lack of marketability, such as the higher likelihood that a private company will fail.

Case-by-case examination

Pre-IPO studies generally report average DLOMs in the neighborhood of 45%. Restricted stock studies report lower discounts. But both types of studies show a range of discounts. Some transactions reflect discounts as high as 90%, while others display little or no discount — and some even involve a *premium*.

Because each company and industry is different, calculating the DLOM depends on the facts and circumstances of each case as well as the specific characteristics of the company being valued. (See “Other important DLOM factors” on page 2.)

Don't discount the need for expert analysis

Pre-IPO studies and other empirical measures are valuable tools, but they're no substitute for a thorough analysis of the business being valued. It's important to work with valuation experts who understand the empirical studies and their limitations and know how to adjust marketability discounts to reflect the subject company's unique characteristics. □

It takes one to know one

The role of accounting experts in accountant liability cases

On the surface, accountant liability issues may seem clear-cut. After all, if the numbers in a company's financial statements or other documents are wrong, the accountant must have made a mistake, right?

In practice, it's not nearly that simple. Accountant liability cases are among the most complex areas of the law. Whether an accountant is liable depends on the scope of the engagement and the applicable professional

standards. And, because so much of accounting is based on the exercise of professional judgment, it's possible for financial statements to seem to be wrong even though the accountant did everything right.

Financial experts can help determine whether an accountant carried out his or her professional responsibilities in a competent manner. They also can analyze causation issues and compute potential damages.

Standards for audits

Before evaluating an accountant's compliance with professional standards, it's important to determine which standards apply. But, regardless of the applicable standard, management has primary responsibility for the accuracy of financial statements — the accountant's responsibility is secondary.

An audit provides financial statement users with the highest level of assurance that the statements are fairly presented in accordance with Generally Accepted Accounting Principles (GAAP) and are free of material misstatements.

Accountants performing audits of private companies are subject to Generally Accepted Auditing Standards (GAAS) established by the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA). (See "The GAAS framework" on page 5.) Public company audits are governed by standards set by the Public Company Accounting Oversight Board (PCAOB), which was created by the Sarbanes-Oxley Act of 2002. The PCAOB has adopted GAAS and augmented it with additional standards for public companies.

More limited scopes of engagement

Audits aren't always necessary. The Securities and Exchange Commission (SEC) requires public companies to file annual audited financial statements. Private companies may need them to meet the requirements of lenders or other financial statement users. But, in many cases, the more limited assurance of a review or compilation will suffice.

In a review, the accountant interviews management and conducts an analytical review to determine whether the financial statements are based on appropriate accounting principles, consistently applied. The accountant furnishes a report stating that he or she is unaware of any material departures from GAAP and that the information in the statements appears to be reasonable. But, unlike in an audit, the accountant conducts no testing or other procedures to verify the information. Thus, there's no basis for the accountant to express an opinion on the accuracy of the statements, and thus a review provides only limited assurance.

A compilation doesn't involve any testing, confirmation, inquiry or analytical procedures. The accountant simply compiles data from the company's financial records and formats it in the form of financial statements. But a compilation is much more than a secretarial service: The accountant applies procedures in accordance with GAAP — pointing out any obvious errors or omissions in the financial records and helping the company correct them.

The role of expert testimony

Accountant liability claims may be based on a variety of theories, including negligence or negligent misrepresentation, fraud, breach of contract or federal securities law violations. Each cause of action involves different rules about who can bring a claim and what they must prove. These may vary depending on applicable state or federal law. But a typical claim alleges that:

- The financial statements misrepresent one or more material facts,
- The accountant failed (negligently, recklessly or intentionally) to adhere to applicable professional standards,
- The plaintiff, to whom the accountant owed a duty, justifiably relied on the financial statements, and
- The plaintiff suffered financial damage as a proximate result.



The GAAS framework

As adopted by the American Institute of Certified Public Accountants' (AICPA's) Auditing Standards Board, Generally Accepted Accounting Standards (GAAS) provide:

General standards

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.

Standards of fieldwork

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing and extent of tests to be performed.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of reporting

1. The report shall state whether the financial statements are presented in accordance with Generally Accepted Accounting Principles (GAAP).
2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

There's a common misconception that GAAS prescribes specific tests and procedures an auditor must perform. Because every company is different, however, GAAS simply outlines guiding standards. It's up to the auditor to use his or her professional judgment and experience to determine appropriate procedures based on factors such as the company's accounting system and internal control structure.

Accounting and financial experts can help prove or disprove each element of a claim, but their most important function may be to provide an opinion on the accountant's compliance with professional standards. This can be a challenge for the defense, because often it's difficult to convince a jury that the accountant satisfied his or her duties — even if the

financial statements included misstatements that distort the company's true financial condition.

Consider accounts receivable. To assess whether the financial statement numbers are reasonable, the accountant must make a judgment call as to the receivables' collectibility. The accountant may exercise impeccable

judgment based on the facts at the time of the audit, but future events may change the results dramatically.

An expert also can explain to the jury that, even when accountants are diligent in the performance of their duties and exercise good professional judgment, they may fail to detect errors. This is particularly true when management is actively trying to conceal fraud.

Expert testimony is also critical in determining whether the plaintiff justifiably relied on the information. Financial statements speak only to a company's past results, so investors, lenders and other financial statement users must also analyze other information — such

as economic conditions, industry trends and market forces — to predict the company's future performance. A financial expert can help determine whether the plaintiff adequately considered factors outside the financial statements in its decision-making process.

Reaching the bottom line

Accountant liability cases raise a number of complex issues. Whether you're representing the plaintiff or the defendant, it's important to work with your financial experts to understand the level of services provided, the applicable standards and the factors to consider in evaluating the accountant's performance. □



The impact of lockstep transfers on minority discounts

Should a minority interest discount be reduced when an owner transfers the minority interest as part of a “lockstep” transaction — that is, when several minority shareholders act together to transfer a controlling interest as part of a prearranged plan?

In *Koblick v. Commissioner*, the U.S. Tax Court said it should be reduced but shed little light on the reasoning behind its decision.

Petitioners seek watered down discounts

The petitioners in *Koblick* owned a 45% interest in Sealodge International Inc., whose primary asset was a submersible barge used as an underwater “lodge” for marine researchers. The petitioners transferred their interest to a charitable organization in exchange for \$90,000. At the same time, the remaining shareholders transferred their interests to the organization. On their federal income tax return, the petitioners claimed that the stock's fair market value was \$810,000, resulting in a charitable gift of \$720,000.

In addition to arguing that the lodge was overvalued, the IRS applied a 22% minority interest discount. The petitioners countered that, because the shareholders acted together to transfer 100% of the corporation's stock, no discount was warranted. The court noted that ordinarily the tax is based on the value of the interest transferred, not on what the transferee ultimately receives. But it acknowledged that a lower discount might be appropriate when several shareholders transfer a controlling interest as part of a prearranged plan.

Prior case cited

The court cited *N. Trust Co. v. Commissioner*, in which four shareholders agreed to transfer each of their 25% noncontrolling interests in a closely held corporation to some long-term trusts. The taxpayers argued for a 90% minority interest discount, but the Tax Court allowed only a 25% discount. Because of the taxpayers' prearranged agreement, they “marched in lockstep” and “so marching, their position was no different than that of a single majority shareholder.”

Although the court ultimately applied a 10% discount in *Koblick*, it didn't explain its reason for doing so.

Regular property valuation critical with coinsurance clauses

Maintaining adequate insurance coverage is critical to your litigation clients, but in many cases a misunderstanding of key policy provisions can dramatically reduce the recovery amount.

One of the most misunderstood — and potentially damaging — policy provisions is the coinsurance clause. This clause requires the client to insure a specified percentage of a property's value, usually in exchange for a lower premium, in order to collect the full amount of a loss. If the client fails to maintain the required level of insurance, a “coinsurance penalty” can drastically reduce its recovery on claims.

How it works

Coinsurance provides an incentive for the insured to maintain adequate insurance coverage. The insurance company's objective is to prevent a full recovery by an insured party who underpays premiums relative to the risk the insurer assumes.

For example, a property insurance policy with a coinsurance clause may require the insured to maintain coverage at a level equal to 80% of a building's value. If coverage drops below that level (because the building appreciates in value, for example), the insured must either increase the amount of coverage or share the risk of losses (including partial losses) with the insurer.

The formula for calculating the recoverable loss under a coinsurance clause is:

$$\frac{\text{Amount of insurance carried by the insured}}{\text{Amount of insurance that should be carried}} \times \text{Amount of the loss} = \text{Payment}$$

Let's look at two examples:

Example 1. Mort owns a building valued at \$1 million. His insurance policy contains an 80% coinsurance clause, under which he must maintain insurance coverage equal to 80% of the building's value.

As required, Mort maintains \$800,000 worth of coverage on the building. If the building suffers \$200,000 in damage, Mort will recover the full amount of his loss:

$$\frac{\$800,000}{\$800,000} \times \$200,000 = \$200,000$$

Example 2. Ten years later, the building from Example 1 has increased in value to \$2 million, but Mort never changed his insurance coverage. Under the coinsurance clause, he should have increased the coverage to 80% of \$2 million, or \$1.6 million. Now, if the building suffers \$200,000 in damage, Mort will recover only 50% of his loss:

$$\frac{\$800,000}{\$1,600,000} \times \$200,000 = \$100,000$$

As these examples illustrate, it's important for clients to obtain regular valuations of property to make certain they're not underinsured.

How to keep coverage up-to-date

Clients often agree to coinsurance provisions to control premium costs, but, unless they're diligent about maintaining adequate levels of coverage, the potential reduction in payments can eclipse any premium savings. One potential alternative is to use a higher deductible, which may be a less risky way to reduce premiums. A financial expert can help strike the right balance between controlling costs and ensuring a full recovery in the event of a loss. □



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For more than 20 years, Hooper Cornell's team of CPAs, economists, Certified Fraud Examiners, Accredited Senior Appraisers, MBAs and Chartered Financial Analysts has helped legal professionals throughout Idaho and around the country analyze and understand cases involving many types of economic disputes, including commercial litigation, business valuation, personal injury, health care litigation, divorce and fraud. We provide focused evaluations, sound conclusions and expert testimony that translate complex concepts into language that clients, juries and judges can easily understand.



KENNETH HOOPER, CPA, CFE, CHC is a Certified Public Accountant (CPA) in Washington, Idaho and Georgia. He is also a Certified Fraud Examiner (CFE), certified by the Association of Certified Fraud Examiners and is certified in Health Care Compliance (CHC) by the Health Care Compliance Association. Ken has worked as an accountant and consultant to health care providers since 1985. His work involves operations and compliance reviews, self-reporting of overpayments, negotiated settlements with government agencies and consulting in litigation or pre-litigation matters.



DENNIS REINSTEIN, CPA/ABV, ASA, CVA is a partner with over 33 years of experience in accounting, auditing, business valuation and taxation. He has extensive experience in assisting clients with business performance and ownership succession, and has valued hundreds of closely-held businesses in many industries for purposes of estate, gift, dispute resolution, sales and mergers. Dennis holds degrees in Agribusiness and Accounting from the University of Idaho. His previous experience as a loan officer for the Farmer's Home Administration included conducting residential real estate and farm appraisals.



PETER BUTLER, CFA, ASA is a Director of Valuation and has more than 13 years of business valuation, litigation support and venture capital experience. Peter developed the Butler Pinkerton Model™, a web-based application to quantify company-specific risk for guideline publicly traded companies - a first for the business valuation industry. Peter also has spoken at numerous national and regional business valuation conferences on the topic of company-specific risk. A former U.S. Naval Officer, Peter has a BS in mechanical engineering from the U.S. Naval Academy and an MBA from San Diego State University.



KEITH PINKERTON, CFA, ASA is a Director of Valuation and has more than 13 years experience providing economic consulting, valuation and litigation support services. His practice focuses on the analysis and appraisal of closely-held companies, preferred stock, debt securities, pass-through entities and intangibles such as patents and trademark rights. Keith has earned a Masters of Business Administration degree from Baylor University and a Bachelor of Arts degree in Economics from the University of South Florida.



KATHERINE JONES, CPA, CFE, Manager, has more than 25 years of experience in accounting, auditing, taxation, fraud investigations and consulting. She provides fraud investigative services for private and governmental agencies, and litigation support in various areas, including family law. A consultant to the health care industry on accounting systems, operations management and compliance, Katherine holds a BS from Lewis-Clark State College and is a Certified Fraud Examiner.



MARION DEMARIA, CPA, is a Senior Manager with more than 15 years of experience in accounting, taxation and personal injury litigation, as well as previous experience as an in-house accountant for a manufacturing company. She holds a degree in Economics from Boston University and is licensed to practice in Idaho as a Certified Public Accountant.

