



Financial Expert

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Down for the count

Detecting inventory fraud

Like any type of employee scam, inventory fraud can lead to losses that can go undetected for long stretches of time. Many companies are particularly vulnerable to such fraud, though, because of risks that are inherent in the way they do business.

3 common fraud techniques

It's not just sticky fingers that companies need to worry about with their inventory. Several other fraud techniques are also common and potentially more costly. Three in particular are:

- 1. Fake sales.** The employee on the cash register fails to ring up an item for an accomplice or rings it up at a lower price.
- 2. Returned goods.** The register worker rings up an item at a lower price and subsequently processes a return for the accomplice at the full price.
- 3. Requisition fraud.** A manager inflates customer demand for an item and pilfers the excess items ordered. Or the manager submits an invoice for inventory that wasn't really ordered, diverting the payment to a fictitious business.



Taking stock, getting help

A variety of ill-advised practices can invite inventory fraud. For example, granting too many employees access to inventory can literally leave the door open to theft. Fraudsters can also take advantage of inadequate recordkeeping systems and a company's failure to track every item with location assignments. In addition, weak purchasing, receiving and disbursement controls make it easy for perpetrators to cover their tracks.

Who can help detect these weak spots? A fraud expert. In examining a company's financial records, he or she can look for unusual journal entries posted for inventory, such as an entry making a physical count adjustment during a time when no inventory count had been conducted.

A fraud expert will also scan the books for large adjustments after physical inventory counts, significant drops in gross margins and repeated issues with out-of-stock inventory. Moreover, he or she may check for invoices or purchase orders with no corresponding record of delivery, as well as discrepancies among the amounts due according to the invoice, the purchase order and the payment record.

An inventory fraud investigation goes beyond the company's books and financial statements, too. An expert might find hints of inventory fraud in documents such as vendor lists — revealing vendors that are using post office boxes or multiple addresses, which are possible signs the business is paying a fictitious vendor.

Reducing your risk

Unfortunately, some amount of fraud in any organization is virtually inevitable. But companies can reduce their risk of losses, whether from inventory fraud or other crimes, by establishing a formal fraud prevention policy and implementing an anonymous tip line. ♦

Understanding the “fair value” standard

Different valuation assignments call for different standards of value. Minority shareholder dissension and oppression cases can be especially tricky. Here are some considerations that affect an appraiser’s approach to these cases — and, ultimately, the estimated value of minority interests.

MBCA definition

Most states have adopted the ABA’s Model Business Corporation Act (MBCA) or a close approximation thereof. MBCA addresses how to remedy abusive practices against or complaints by minority shareholders. It also prescribes “fair value” as the appropriate standard of value to buy out minority shareholders. Specifically, the MBCA defines “fair value” as:

The value of shares immediately before the corporate action to which the dissenter objects using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal, and without discounting for lack of marketability or minority status except, if appropriate, for amendments to the certificate of incorporation pursuant to section 13.02.

Courts have interpreted this definition different ways, depending on legal precedent and what the judge deems “fair and equitable” given the facts of the specific case.

This standard differs from “strategic value” in mergers and acquisitions, which is the value to a specific buyer and seller. And it’s unlike the “fair market value” standard applied in tax cases, which IRS Revenue Ruling 59-60 defines as:

The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm’s length in an open and unrestricted market,



when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

The parties in dissenting or oppressed minority shareholder lawsuits are neither hypothetical nor willing.

Sticking points

When the court orders a buyout, minority and controlling shareholders argue about many subjective valuation assumptions, including:

- ◆ Appropriate methodology (cost, market or income approach),
- ◆ Selection of guideline transactions,
- ◆ Management projections,
- ◆ Rates of return, and
- ◆ Valuation date.

But the primary point of contention in shareholder disputes is whether to apply valuation discounts, such as discounts for lack of control and marketability and for built-in capital gains tax. Each discount can be sizable, reducing value by 20%, 35% or more.

Accounting's take on "fair value"

When reading articles about "fair value," attorneys and their clients should know that the term takes on a different meaning in an accounting context. Approximately 40 different precodification Financial Accounting Standards Board (FASB) statements refer to the term "fair value," including Statement No. 141, *Business Combinations* (now classified under FASB Codification Topic 805, *Business Combinations*); Statement No. 142, *Goodwill and Other Intangible Assets* (now classified under FASB Codification Topic 350, *Intangibles – Goodwill and Other*); and Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (now classified under FASB Codification Topic 820, *Fair Value Measurements and Disclosures*).

In September 2006, FASB Statement No. 157, now classified under Topic 820, provided a universal definition of fair value that supersedes any previous versions:

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.

Similar in many respects to fair market value — which is defined in IRS Revenue Ruling 59-60 (see main article) — FASB chose the term "fair value" to prevent companies from using an IRS guideline or a Tax Court precedent when valuing assets and liabilities for financial reporting purposes. FASB also uses the term "market participants," which refers to buyers and sellers in the asset's or liability's principal market. The principal market is entity specific and may vary among companies.

Bottom line: Just because a company has hired an appraiser to assess fair value for one purpose, that valuation may not be valid for other purposes — especially when different "as of" dates apply.

The courts' approach

Most courts — including those in Delaware, the state with the most dissenting shareholder legal precedent — grant minority shareholders their pro rata share of the entire business's value on a controlling, marketable basis. In other words, no discounts apply and a control premium may be



added, depending on the appraiser's methodology. This interpretation is consistent with the revised MBCA definition.

The underlying logic for excluding valuation discounts is that controlling shareholders shouldn't receive a windfall for mistreating minority owners. Moreover, a court-mandated buyout provides an immediate market for minority shareholders' interests.

But exceptions exist. For example, it's common practice in New York — another source of significant shareholder dispute case law — to apply marketability discounts in dissenting and oppressed shareholder cases.

Significant leeway

When valuing minority interests, courts are granted significant leeway; what's fair and equitable is determined on a case-by-case basis. Credentialed appraiser testimony and detailed valuation reports are critical in helping judges sort through case facts and technical analyses. ♦

No hats involved

Discounts for lack of marketability call for a detailed process

When calculating any valuation adjustment, an appraiser obviously can't just pick a number out of a hat. But the discount for lack of marketability (DLOM) is an often-contested valuation adjustment that requires a particularly detailed process.

The application of DLOM

The International Glossary of Business Valuation Terms defines marketability as “the ability to quickly convert property to cash at minimal cost.” Public stock is generally easy to sell because stock exchanges provide a ready market. In contrast, private business interests can require significant time, money and effort to sell.

Despite these marketability differences, appraisers often turn to public stock data when estimating the value of private firms. Because such methodology sometimes results in apples-to-oranges comparisons, appraisers may apply DLOMs to their preliminary value estimates. Such discounts account for the illiquidity of private business interests relative to public stocks.

Restricted stock studies

A DLOM is stated as a percentage reduction in the subject company's value. Appraisers typically quantify this percentage for noncontrolling private business interests using empirical evidence.

One example is restricted stock studies. Some companies issue restricted (or letter) stock in mergers or acquisitions or to raise private capital without registering new shares. Restricted stock is identical to freely traded stock, except that it's subject to a minimum one-year holding period. Public companies must report restricted stock transactions to the SEC.

A restricted stock study compares restricted stock prices to freely traded stock prices on the same day to estimate the DLOM. Analysts

hypothesize that the key difference between restricted stock and freely traded stock is the degree of marketability. IRS Revenue Ruling 77-287 specifically endorses the use of restricted stock transaction data to support the DLOM for private business interests.

Another source

An appraiser may also look at pre-initial public offering (pre-IPO) studies. The SEC requires companies to disclose all stock transactions (including stock options) within three years of going public. A pre-IPO study compares these private transactions to the company's IPO price.

Some studies exclude non-arm's-length transactions, such as those involving company insiders and stock options. Others attempt to adjust stock prices for changes in market conditions between the private transaction date and the IPO date.



Whereas restricted stock studies compare different types of publicly traded interests, pre-IPO studies provide direct comparisons of a company's private stock price to its public price. Consequently, the average discounts published in pre-IPO studies are generally higher than those observed in restricted stock studies.

Matters of size

In general, empirical studies suggest a range of median DLOMs from 35% to 50%. But the actual DLOM an appraiser assigns to a specific business interest can vary significantly from the norm, depending on the investment's characteristics.

It's important to note that the more potential buyers interested in a company, the lower its DLOM.

It's paramount for appraisers to evaluate specific attributes — such as profitability, financial position, liquidity, transfer restrictions and expected holding period — regarding their effect on marketability. Appraisers who merely

rely on average (or median) discounts from restricted stock or pre-IPO studies are unlikely to survive a deposition or cross-examination.

Key considerations

When quantifying a DLOM, strong performance (such as high profits or low leverage) generally correlates with a lower discount. The risk of a company's underlying assets also affects its DLOM.

Moreover, investors place a premium on reliable financial data and professional management. Dividends matter, too — companies that distribute cash to investors provide an immediate return on investment, thereby lowering DLOMs. It's also important to note that the more potential buyers interested in a company, the lower its DLOM.

A deeper dig

At the end of the day, a DLOM based only on empirical study averages may not withstand scrutiny. That's why appraisers are digging deeper than ever for more meaningful, defensible comparisons. For example, there are quantitative methods (such as those based on discounted cash flows) to derive a DLOM estimate. Ultimately, it's a complex process that calls for specialized expertise. ♦

Hawaiian divorce case puts valuation evidence to the test

A valuation's purpose affects an appraiser's methodology and analyses. What's allowed in tax court, such as buy-sell agreements or valuation discounts, may be excluded from evidence in, say, divorce court.

A credible appraiser, however, can help persuade judges to accept valuation evidence that's reasonable and fair. A recent divorce case in Hawaii, *Doe v. Roe*, provides an interesting example.

Contested issues

A confidential order conceals the parties' names, the nature of their investments and the specific valuation methodologies used in the case. But it's known that, on appeal, the wife specifically contested the following valuation-related issues:

The value of the husband's CLH capital contribution credit. Before getting married in 1994, the husband owned 834 shares of CLH, a

privately held business. The marital estate included appreciation in value from February 1994 to June 2006 (the divorce date). In other words, the June 2006 value of the husband's interest in CLH should be offset by a capital contribution credit equal to the date-of-marriage value of CLH.

The wife argued that the capital contribution credit should be \$923,729, based on a "0.50 times annual revenues" formula prescribed by CLH's stock redemption agreement. The husband argued that the capital contribution credit was \$2.5 million, based on CLH's repurchase of another shareholder's stock in 1989 and 1990. The previous transactions applied a multiple of 1.5 times annual revenues. The husband's 1992 and 1996 personal financial statements also valued CLH stock at \$2.5 million.

Even though the wife contended the 1989-90 stock buyouts included the value of noncompete agreements, the Family Court of the Third Circuit (Kona Division) accepted the husband's date-of-marriage value. The Hawaii Intermediate Court of Appeals upheld this decision.

The value of the husband's interest in PPPI.

The husband owned a 7% interest in PPPI, another private business, before the marriage. The parties agreed to the date-of-marriage value of this interest. But they disagreed about its June 2006 value, which was needed to estimate the asset's appreciation during the marriage.

The husband's expert concluded that the value of PPPI had actually decreased during the course of the marriage. The expert valued the interest at \$87,769 on June 30, 2006. This opinion conflicted with (and is lower than) an August 2002 valuation of PPPI that was used in two subsequent stock transactions. The husband's expert explained that the previous valuation had been based on future income projections in June 2002 that didn't materialize for the turbulent economy.

The wife didn't present any valuation evidence to support a higher value, so the family court accepted the husband's value. The appellate court affirmed.



Value of husband's interest in M Corporation.

Before the marriage, the husband's parents gifted each of their five children a 20% interest in a real estate holding company called M Corporation. Its primary asset is a Honolulu residential property.

The family court ruled that the husband's interest in M Corporation is a marital asset. Despite testimony from the wife's expert that discounts were inappropriate, the court accepted the value set forth by the husband's expert, which included discounts for lack of control and marketability. The appellate court again affirmed.

Lessons learned

An accurate depiction of value requires an appraiser to assemble many pieces. In addition, trial courts are granted wide discretion in making decisions, including what kind of valuation evidence is accepted in a given case.

In *Doe v. Roe*, the court was asked to consider a wide range of items — including stock redemption agreements, prior transactions, personal financial statement values, previous valuations and valuation discounts. All of these factored into the trial court's decision and, as the case demonstrates, once a trial court has laid down the law, it's hard to get an appellate court to overrule the decision unless it's clearly erroneous or abusive. ♦



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New Federal Discovery Rules for Experts

Effective December 1, 2010, draft reports produced by experts in federal cases, as well as most of their communications with counsel, is no longer discoverable.

Before the amendment, Federal Rule of Civil Procedure 26 (“Rule 26”) often required experts to produce all communication with counsel. Experts could also be required to produce any drafts of their expert reports, resulting in additional discovery and confusion. Experts often grappled with what exactly defines a draft, from auto-saved versions, to typo changes, to printed drafts. Experts were often asked to avoid emails with counsel, instead communicating through time-consuming conference calls. Also, each jurisdiction could have its own interpretation on what exactly was discoverable creating inconsistencies among the courts. Many complained that the additional discovery of expert communications and drafts was an unnecessary and costly burden.

Changes to Rule 26 help alleviate that burden. The broad phrase “data or other information” in Rule 26(a)(2)(B)(ii), previously relied upon to trigger discovery of expert drafts and communications, was replaced with “facts or data”, narrowing the discoverable information. Rules 26(b)(3)(A) and (B) “protect drafts of any report or disclosure” of expert witnesses, regardless of the draft form.

Communications between counsel and the expert is also protected, except when the communication:

- (1) Is related to expert compensation in the case;
- (2) Identifies facts or data that the expert is relying upon in forming his or her opinions;
- (3) Identifies assumptions that the expert is relying upon in forming his or her opinions.

The amendments to Rule 26 should be beneficial to everyone involved. Experts can now communicate with attorneys through more modern methods like email without the fear of communication discovery. Attorneys can see drafts of expert reports and not be surprised by damage theories or the amount of damages. And the decrease in discovery should lower costs, a benefit that every client can be happy about.

Keep in mind that most state courts have not fully adopted the new amendments as it relates to expert discovery. So your emails, and possibly your draft work product, could still be discoverable in state cases.

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