HENDERSON HUTCHERSON
& MCCULLOUGH, PLLC
FORENSICS | LITIGATION | VALUATION

## FEATURED ARTICLES:

- Calculations vs. Conclusions: Know the Differences
- Biotronik A.G. vs. Conor Medsystems Ireland, Ltd.: Toeing the Fine Line Between General & Consequential Damages
- Trouble Ahead: Finding the Value of an Underperforming Company
- Revised AICPA Ethics Rules May Affect Your CPA Experts

HENDERSON HUTCHERSON & McCULLOUGH'S FEBRUARY 2015

# FORENSICS LITIGATION & VALUATION INSIDER

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# CALCULATIONS VS. CONCLUSIONS

## KNOW THE DIFFERENCES

It's critical for attorneys to understand the differences between a "*conclusion of value*" and a "*calculation of value*." Although the two terms sound similar, relying on the latter in the courtroom can lead to embarrassment – or, worse, cause your client to lose the case.

*To provide a value conclusion, an expert uses all relevant valuation approaches to arrive at an opinion of the value of a business, a business interest or another asset. In providing a value calculation, on the other hand, the expert and client agree in advance on the approaches to be used and the procedures to be performed. A calculation engagement doesn't produce a value opinion.*

*A value calculation can be a cost-effective tool for planning or settlement discussions. But to prove your case in court, only a value conclusion will do.*

## TWO APPROACHES

1

The American Institute of Certified Public Accountants (AICPA) Statement on Standards for Valuation Services No. 1 spells out the differences between valuation and calculation engagements. *In a valuation engagement, the valuator:*

- *Analyzes the subject interest*

- *Considers and applies appropriate valuation techniques, including the cost, market and income approaches*

- *Prepares and maintains appropriate documentation, including a detailed or summary valuation report that provides a conclusion of value (either a single amount or a range) (see the sidebar "What should a valuation report contain?")*

- *Arrives at a conclusion of value*

2

*In a calculation engagement, the valuator and client agree on the valuation approaches and methods to be used – as well as the procedures to be performed in calculating value.* Generally, these procedures are more limited than those used in a valuation engagement. For example, a calculation engagement might not require the valuator to interview management or conduct site visits.

The valuator expresses the results as a calculated value, rather than an opinion of value. Any written or oral report must state that it's a calculation report and detail all applicable assumptions and limitations.

## USE CALCULATIONS WISELY

*Under the right circumstances, a calculation of value can be an effective tool for streamlining the valuation process and minimizing costs.* A calculation engagement might be appropriate for:

- Litigation planning or preliminary investigations

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• Settlement discussions in connection with business litigation or marital dissolution proceedings

• Preliminary planning for a business sale, merger or other transaction

*Once the matter escalates to the litigation stage and it becomes necessary to establish value to a trier of fact, a calculation of value will no longer suffice.* Calculations typically include a disclaimer that says, "Had a valuation engagement been performed, the results may have been different."

## CASES IN POINT

Litigants who attempt to use calculations of value in the courtroom often discover that their calculation reports are insufficient to support their cases. Here are two recent examples:

**IN RE-MARRIAGE OF HAGAR.** This marital dissolution case required valuation of the husband's interest in a family-owned dry cleaning business. The family's accountant estimated that the business's value ranged from negative $120,000 to $71,329. But the accountant testified, "This is not a valuation. This was a computation, utilizing rules of thumb that are documented as industry standards but not using judgment."

The trial court valued the business using the accountant's calculations, but the court of appeals reversed, noting that the accountant by his own admission didn't "use judgment." In particular, the appellate court criticized the accountant's failure to recognize the impact of family ownership on business value, noting that the husband unilaterally discontinued distributions after his wife filed for divorce.

**SURGEM, LLC V. SEITZ.** In this dispute over the size and fair value of the defendant's interest in the plaintiff, the court rejected the testimony of the defendant's expert and accepted the plaintiff's conclusion of value. The court explained that the defendant's expert "did not appraise the fair value of Surgem or of Seitz's interest; rather he testified that he had been engaged to prepare only a 'calculation of value.'" The expert also testified that the defendant didn't supply him with numerous materials necessary for a valid opinion and that more work should have been done to arrive at an opinion of the business's fair value.

## BE PREPARED

When litigation involves the value of a business, a business interest or another asset, don't go to court without a properly documented conclusion of value prepared by a qualified valuation professional. •

### SIDEBAR:

## WHAT SHOULD A VALUATION REPORT CONTAIN?

When a valuator provides a conclusion of value, his or her report should contain sufficient information so that a judge, jury or other user can understand the data, reasoning and analyses underlying the conclusion. The specifics depend on applicable valuation standards. Although an oral report may meet these standards, in a litigation context a written report is generally preferable. Typically, the standards spell out what a written report should cover. For example, Statement on Standards for Valuation Services (SSVS) No. 1 provides for a detailed or a summary valuation report, and recommends that a detailed report include:

- Letter of transmittal
- Table of contents
- Introduction
- Sources of information
- Analysis of the subject entity and related nonfinancial information
- Financial statement and information analysis
- Valuation approaches considered
- Valuation approaches used
- Valuation adjustments
- Nonoperating assets, nonoperating liabilities and excess or deficient operating assets (if any)
- Representation of the valuation analyst
- Reconciliation of estimates and conclusion of value
- Qualifications of the valuation analyst
- Appendices and exhibits

There is some flexibility – for example, the report might contain an index instead of a table of contents. SSVS No. 1 also provides details on the content of each of these sections.

BIOTRONIK A.G. VS.
CONOR MEDSYSTEMS IRELAND, LTD.

# TOEING THE FINE LINE BETWEEN GENERAL AND CONSEQUENTIAL DAMAGES

In this case, the New York Court of Appeals discussed the distinction between general and consequential damages. *At stake was $85 million in alleged damages for breach of an exclusive distribution agreement. Like many commercial contracts, the agreement limited the parties' liability to general damages, providing that "neither party shall be liable to the other for any indirect, special, consequential, incidental, or punitive damage with respect to any claim arising out of this agreement."*

*The issue was whether the plaintiff's alleged lost profits were general damages, which could be recovered, or consequential damages, which could not.* The appellate court held that lost profits were "the direct and probable result of a breach of the parties' agreement" and, therefore, constituted general damages.

The 2004 agreement in this case was between Biotronik, a medical device manufacturer and distributor, and Conor Medsystems Ireland (Conor), the developer and manufacturer of a coronary stent called CoStar. Under the agreement, Biotronik agreed to serve as Conor's exclusive worldwide distributor of CoStar to both end users and resellers.

*Unlike a simple resale contract, the agreement required Biotronik to pay Conor a transfer price equal to a specified percentage of Biotronik's net sales.* Each quarter, the parties calculated a minimum price based on the preceding quarter's net sales, but Biotronik had to pay the full transfer price even if the actual sales price exceeded the minimum price. *In other words, Biotronik's payment obligation arose only if it made sales of CoStar, and the amount Conor received was directly related to the market price Biotronik could obtain.*

In 2007, Conor recalled CoStar and took it off the market after FDA trials failed to establish that CoStar was equivalent to another widely marketed stent. *In the ensuing breach-of-contract litigation, both the trial court and the Appellate Division ruled that Biotronik's lost profits were consequential damages barred by the provision quoted above. The New York Court of Appeals reversed, finding that the lost profits constituted general damages.*

The high court reviewed relevant breach-of-contract cases under which lost profits may be either general or consequential damages, depending on the particular facts and circumstances. *"The distinction at the heart of these cases," the court explained, "is whether the lost profits flowed directly from the contract itself or were, instead, the result of a separate agreement with a nonparty."* But that doesn't necessarily mean that lost resale profits, which by definition involve third-party transactions, are always consequential damages.

*In the case at hand, the court said, the agreement – by using Biotronik's resale price as a benchmark for the transfer price – "clearly contemplated that plaintiff would resell defendant's stents. That was the very essence of the contract."* Thus, Biotronik's lost profits were "the natural and probable consequence" of Conor's breach.

*One lesson from this case is that contracting parties should expressly spell out in the contract whether lost profits constitute general or consequential damages.* Doing so would minimize disputes over how to properly categorize losses in any future breach-of-contract litigation.

# REVISED AICPA ETHICS RULES MAY AFFECT YOUR CPA EXPERTS

If you work with financial expert witnesses or consultants, it's important to familiarize yourself with the American Institute of Certified Public Accountants (AICPA) "Code of Professional Conduct" and its potential impact on a CPA's ability to provide litigation services. *Last year, the AICPA overhauled the code, reorganizing the rules and introducing new conceptual frameworks for CPAs in public practice and in business.* The revised code took effect Dec. 15, 2014, with a one-year delay for the new conceptual frameworks.

*The conceptual frameworks adopt a "threats and safeguards" approach.* In situations not specifically addressed by the code, CPAs should evaluate their risk of real or perceived noncompliance by:

1. Identifying threats to compliance.
2. Determining whether the significance of a threat is at an "acceptable level".
3. Identifying and applying safeguards that eliminate the threat or reduce it to an acceptable level.

*Generally, threats fall into one of the following categories: adverse interest, advocacy, familiarity, management participation (for CPAs in business), self-interest, self-review and undue influence.*

*One significant change in the revised code involves forensic accounting services.* An example of an advocacy threat under the conceptual framework is when "a member provides forensic accounting services to a client in litigation or a dispute with third parties." Under the previous version of the code, some forensic accounting services, such as expert witness engagements, were deemed to impair a CPA's independence when he or she performs an attestation engagement (when a CPA expresses a written conclusion about the reliability of another party's assertion) for the same client. *The revised code's conceptual framework suggests that providing forensic accounting services to nonattest clients also may threaten independence.*

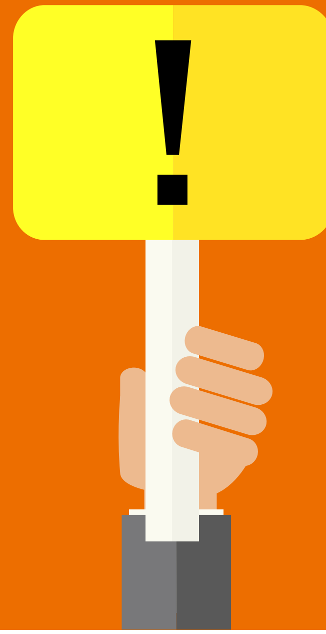
*As before, the revised code states that a CPA who provides expert witness services for an attest client creates the appearance that he or she is advocating or promoting the client's position, an impairment of the CPA's independence that can't be cured by applying safeguards. Independence isn't impaired, however, if a CPA provides expert witness services to a large group of plaintiffs or defendants, as long as 1) the CPA's attest clients constitute less than 20% of the group, 2) no attest client serves as lead plaintiff or defendant and 3) no attest client has sole authority to select or approve the expert witness.*

Providing litigation consulting services may also constitute a threat to CPA independence. In most cases the threat can be reduced to an acceptable level by following the AICPA's "General Requirements for Performing Nonattest Services."

*This is just a sampling of the revised code's guidance to avoid potential conflicts of interest.* Before you go to court, review these changes with your CPA expert to ensure compliance with the latest ethics rules.

# TROUBLE AHEAD!

## FINDING THE VALUE OF AN UNDERPERFORMING COMPANY



Underperforming companies present special valuation challenges. Financial distress adds an element of risk, which lowers value. So, *compared with healthy companies, distressed businesses tend to have higher discount rates (under the income approach) and receive downward adjustments to pricing multiples (under the market approach), and sometimes don't have past or projected earnings that contribute to the company's value (under the cost approach).* Or valuators might select guideline companies with similar financial performance or a proximate transaction date to avoid using deals that occurred during better economic times.

### THE WARNING SIGNS

In every assignment, appraisers assess and benchmark financial health against industry norms. Warning signs of financial distress include:

- weak demand
- scaled-back corporate budgets
- rising commodity prices
- tighter credit

Financial statement trends – such as recurring net losses, declining or erratic sales growth and deteriorating liquidity – also are telltale signs that a company is in trouble. *Examples of other red flags include late or missing financial records, high employee turnover and low morale. Also evaluate fixed-assets records.* For instance, distressed sellers may defer maintenance, repair and equipment updates – or they may sell off fixed assets to generate extra cash flow.

When valuators recognize these signs, they can modify their appraisal approach to avoid over- (or under-) valuing a distressed business.

### THE FUTURE VS. THE PAST

*When buying a distressed business, liquidation value may be more important than going-concern value, particularly if the seller is under duress to exit the business.* If liquidation value is the "floor" for purchasing a distressed business, strategic value is the "ceiling."

In orderly liquidation value, valuators consider what the company would receive at an auction – and then subtract outstanding debt obligations. Strategic (or investment) value is the value to a particular investor based on individual investment requirements and expectations. For example, a competitor can afford to pay extra for buyer-specific synergies and economies of scale. (See the sidebar "Investment benchmarks.")

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## BE REALISTIC

*Distressed company sales and auctions may offer bargains, but don't let rock bottom prices cloud your business judgment. Acquisition due diligence is exceedingly important. It's imperative that business owners realistically assess the value of distressed businesses and their assets.* •

FOR MORE INFORMATION ON UNDERPERFORMING COMPANIES, CONTACT THE HHM | FORENSICS LITIGATION & VALUATION TEAM TODAY.

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### SIDEBAR:

## INVESTMENT BENCHMARKS

The following financial metrics can help buyers evaluate whether asking prices make sense:

**ACCOUNTING PAYBACK PERIOD.** This tool estimates how long an investment will take to recoup its initial cost. For example, the payback for a machine that costs $200,000 and generates $40,000 in annual incremental profits is five years.

**BREAKEVEN POINT.** Breakeven predicts how many units must be sold for an investment to cover its incremental costs. It equals incremental fixed costs (including depreciation) divided by the contribution margin per unit (which is equal to the price per unit minus the variable costs). If sales volume exceeds breakeven, an investment will generate profits.

**NET PRESENT VALUE.** Here the analyst converts an investment's projected cash flows to present values using an appropriate risk-adjusted discount rate. Buyers typically discount an investment's cash flow using their cost of capital. Net present value equals this discounted cash flow. If net present value is greater than zero, an investment makes sense.

# LET THE HHM FLV TEAM HELP YOU TODAY

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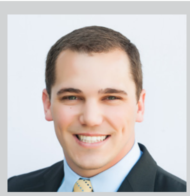
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