



Checklist: Make Sure Your Expert Survives a Daubert Challenge

Why do experts get excluded from court? Lack of reliability is the leading cause under the Daubert standard, followed by lack of relevance and lack of qualifications, according to the most recent studies. Methodological flaws caused by the misuse of accepted financial and/or economic methods are also a frequent basis for denying financial expert testimony. And, of course, any new or untested approach will receive heightened scrutiny, under Daubert's by now familiar four-part test:

- Has the theory or technique been scientifically tested?
- Has the methodology been peer-reviewed and published in professional journals?
- Does it have a known error rate, with established standards to control its use?
- Is the methodology generally accepted by the relevant professional community?

Thirteen questions for your expert. Nearly 18 years after the U.S. Supreme Court's decision in Daubert (1993), only about half of states apply the federal standard. The remaining apply the "general acceptance" test of Frye v. U.S. (D.C. Cir. 1923), or some hybrid or independent standard. Thus it's important for attorneys to know their local court rules, to understand how high they have set the admissibility hurdles for expert testimony. For those jurisdictions that apply Daubert or a similar standard, the following 13-point checklist will help you evaluate your financial experts prior to litigation. If the experts can't answer any one question to a satisfactory degree, perhaps they shouldn't be retained in the case.

1. Do you have the requisite background, training, and experience required to gain acceptance by a court if a Daubert hearing is held?
2. Is it realistic to expect that your testimony will be admissible?
3. Has anyone performed a review of your work to see if it appears reasonable? "I'm lucky—I have the luxury of asking folks in my office to help me," Michael Costello said. When he was a solo/small firm practitioner, he would pay his peers to review his report.
4. Have you followed all relevant professional standards? These can include the standards promulgated by the American Society of Appraisers, the AICPA, The Appraisal Foundation (Uniform Standards of Professional Appraisal Practice), etc.
5. Have you used proven, commonly accepted valuation methodologies? Is the method generally endorsed by experts in the field? Can you cite relevant publications to support them?
6. If you apply an unusual or novel method, has it been peer-reviewed? If so, is there a basis on which the method would gain general acceptance in the BV professional community?
7. Does your work fit the case? Are your assumptions reasonable, given the underlying facts? (Attorneys: Make sure to clarify which facts will be admissible at trial.)
8. Is the underlying data reliable? Did you take reasonable steps to ensure the accuracy of the information before deriving your conclusions?
9. Have you considered alternative scenarios? This is especially critical in lost profits and economic damages cases, in which causation plays such a critical role.
10. Are your assumptions consistent with the facts?
11. How have you dealt with facts that are inconsistent with the ones you used?
12. Are you familiar with the relevant statutes and

case law to assist in developing a damages or other economic theory?

13. Have you considered the track record of the relevant industry and the performance of comparable companies within that industry? Note: In the current economy, make sure your expert understands how the subject company and its comparables are faring.

Exit Planning Made Easy— with the Aid of a Good Business Appraiser

Credentialed business appraisers have a valuable but often overlooked function: to serve as financial facilitators for privately held and/or family-run companies that are contemplating succession. Exit planning typically involves dealing with the tough questions of estate planning, asset values, the age and health of current owners, and the passing of substantial management responsibility to the next generation—who may or may not be ready to take on such a heavy mantle (even if they do want the wealth).

A good succession planner consultant will tackle these sensitive issues up front—while the business is still running smoothly and everyone is in a good position to discuss the options and opportunities. By bringing the entire process to fruition, the business appraiser can help the family avoid personal and financial disasters in the future.

The critical questions. In particular, business succession brings together traditional M&A planning with “key” employee and family considerations, along with buy-sell agreements and related appraisals. Exit planning strategies begin with the broad question: What is the business worth? The discussion branches out into three typical alternatives, each with its own specific issues:

1. **Sell the business.** What are the possible profit motives and value enhancement? What are the potential tax strategies and consequences?
2. **Sell to employees.** Smaller, professional service companies have different concerns—and different layers of organizational and administrative experience—than larger operating companies.
3. **Family transfer.** Gift and estate tax strategies are

implicated here; planning fundamentals include tax consequence, structured vehicles for gifting or transferring the assets; and potential valuation discounts.

In addition, business owners will face some version of the following questions as the process moves forward:

- **What if the business has no significant value?** This is a disappointing conclusion, but a SWOT analysis (strengths, weaknesses, opportunities, threats) can help identify value-creating areas and places for improvement.
- **Asset or stock sale?** Or does an installment sale make sense, to spread the tax consequences over time? For an operating business, would a SERS plan (stock appreciation rights) work? What about an ESOP? What about recapitalizing the business by issuing more stock and then redeeming the founding shareholders’ equity?
- **Internal transfer?** If the owner wants to pass the business onto key employees, consider how they might structure a buy-in that will “incentivize” new partners while providing sufficient retirement for the owner/older partners, and how they might maximize retiring partners’ return without burying the succeeding owners in debt.
- **Family transfer?** How can the owner pass the business to the next generation at the lowest possible transfer/tax costs? How do specific gifting plans and estate options work? What about installment sales of minority shares? How do minority/marketability discounts come into play?

All three tracks end, more or less, in a clear, carefully-crafted buy-sell agreement, for which an accredited business appraiser is ideally suited and indispensable. A buy-sell should balance a number of interests, including the continued viability of the business; the needs of the affected (departing) principals and their families; and the needs of the remaining principals. On balance, the paramount concern must be the continued economic viability and health of the enterprise. Appraisers quantification of value will support the best approach that ultimately works to the advantage of all parties and their financial counselors.

Possible pitfalls in succession plans. Like taxes, most business owners don’t want to think about death or divorce or other painful issues. Similarly, they don’t want to discuss the “death” of their own businesses. A good business succession planner will do everything possible to ease the owner’s pain all the way through the process. This means permitting the owners to:

- Leave the company on their own terms and timetable and not as the result of external, unexpected pressures or sudden deadlines;
- Realize the full value of the business and all their hard-earned wealth, minimizing the impact of transfer and estate/gift taxes;
- Retain control of the situation by entertaining a variety of exit options;
- Suffer the minimum of psychological stress and family conflict;
- Watch a lifetime of work come to a fulfilling, profitable finish; and
- Guarantee the continuity of the business.

Exit planning can be time consuming—and most owners are buried in day-to-day operations and management. The planning process can appear complex and costly. But a financial facilitator can help owners understand the tremendous return on investment that solid exit plans provide. Nothing feels better than bringing the entire organization and family together in a unified plan, and knowing that your business will keep bringing them rewards long into the future.

What to Expect from your Fair Value Specialist: Consistency, Communication—and Sensitivity Analysis

Fair value for financial accounting is here to stay, and as a result independent valuation analysts have grown more sophisticated. Now, financial auditors, lawyers and executives should expect: 1) clear, comprehensive explanation for the reasonableness of fair value assumptions; 2) additional support from sensitivity analyses; and 3) improved communication from their financial experts.

Fair value litigation will increase. Most auditors and economic authorities agree fair value accounting is not responsible for the current financial crisis. At the same time, corporate executives and securities lawyers are looking for a wave of fair value litigation during the next two to five years—in particular, disputes focusing on fair value measurements based on today’s contingencies (earn-outs, etc.) that play out differently in the future. The difficulties of valuing and tracking IPR&D are also

likely to lead to disputes. Plaintiffs are likely to target company insiders and auditors first and then only if they lose, turn on valuation providers.

One way to protect against litigation: More auditors are requesting a reasonable range of values supported by a “confidence interval.” In the international arena, for example, the G20 (group of 20 international finance ministers) has already requested standards for determining the “confidence” underlying an assumption of value; i.e., what is the tightness of the range of values, and what is the sensitivity? The problem: Companies cannot express a range of values on their balance sheets. A possible solution is to include confidence intervals in the footnotes to satisfy investor disclosure requirements. Sensitivity analysis in valuation reports should also emphasize: 1) modeling the distribution of possible outcomes, and 2) more complex valuation techniques.

Question exit assumptions. In today’s market, valuation specialists are also re-examining the exit-pricing assumptions they used to take for granted in valuing equity compensation and stock options. For example, is three years still a fair exit assumption? Probably not, but many of the traditional, commonly accepted stock option pricing models have built-in, limiting variables that might not be appropriate under the current financial circumstances.

By the same token, valuation analysts are re-examining their former reliance on prior transactions to determine fair value of stock options. The more thorough analysts are polling investors for their perspectives before “back-solving” from the latest investment round. If investors do not believe their involvement reflects fair value, it may not be appropriate for the specialist to rely on a back-solve to derive an implied equity value of a company. Instead, the specialist should establish some alternative method for implying fair value along with the audit review team.

On that note, specialists are working hard to forge strong relationships with auditors and reviewers, to improve best practices and service. Clients should now expect the following:

- **Better communication.** Valuation specialists should initiate conversations with the audit review team before starting any project to resolve any potential issues before they become problems. Active communication should continue throughout the valuation process to ensure adequate support for all of the assumptions

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used in the report, especially those generated by management. Effective communication improves the process and reduces reviewing time and expense.

- **More stringent standards.** Audit standards are getting more stringent and audit firms are coming under greater scrutiny. Staff reviewers can no longer simply state that they support the valuation specialists' assumptions as reasonable; they must now document why and anticipate questions regulators might ask in light of elevated standards.
- **Internal improvement.** To remain current, more audit review firms are establishing protocols (on-going internal communications) by which staff discuss trends in recent fair value reports and accepted standards
- **Consistency.** When multiple valuations exist for a single company under various scenarios or standards, the specialist must ensure that all assumptions remain consistent and acknowledge any conflicting outcomes. For example, it's inappropriate to use the same discount rate for two DCF analyses when the market surrounding those cash flows has demonstrably changed.
- **Reasonable ranges.** Similarly, it's a challenge for reviewers to support a valuation specialist's subjective assumptions within a range of reasonableness. Valuers should provide clear narrative support for all assumptions, especially regarding industry and market conditions.
- **Comprehension.** Ideally, the valuation report contains everything the reviewer needs to arrive at the same conclusions, including a clear understanding of the company's potential in light

of current economic trends, the company's stage of development, its business lines and specific performance.

- **Sensitivity.** Once again, reviewers need to establish the reasonableness of assumptions in a valuation report, and will look to see that the specialist has tested the stated assumptions. Sensitivity analysis can offer support for the key variables driving value.



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