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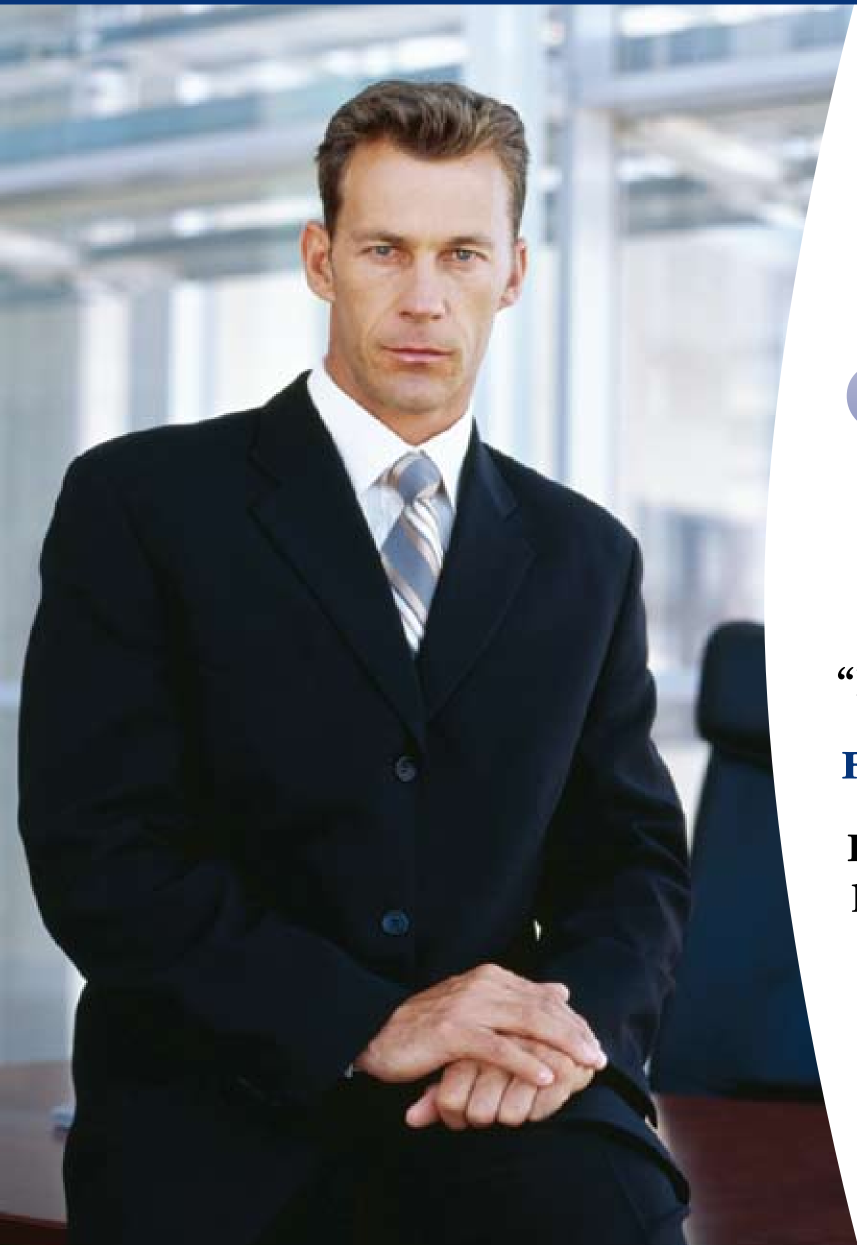

Valuation & Litigation BRIEFING

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“Fair value” in a troubled economy

There’s no question that the struggling economy has had a negative impact on the value of many businesses and investments. But it also influences the business valuation process itself. Because economic conditions may affect the relative reliability of certain valuation methods and approaches, it’s important for you to discuss the potential implications with your valuation experts. In particular, the troubled economy has caused a recent accounting rule change — governing how “fair value” should be measured — to garner a lot of attention.

Fairness doctrine

Last year, Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 157 took effect. The statement, *Fair Value Measurements*, provides guidance on measuring fair value for purposes of several accounting standards. SFAS 157 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.” The underlying measurement objective, according to the FASB, is “generally consistent with similar definitions of fair market value for valuation purposes.”

In an effort to promote more accurate and consistent valuations, the statement establishes a “fair value hierarchy” that emphasizes market-based valuation methods. In valuing an entity under SFAS 157, a valuator should:

1. Give top priority to Level 1 inputs — quoted prices in active markets for *identical* assets or liabilities;

2. Give next priority, when Level 1 inputs aren’t available, to Level 2 inputs — quoted prices in active markets for *similar* assets or liabilities, or other “observable” inputs; and

3. Give lowest priority to Level 3 inputs — unobservable inputs, such as the reporting entity’s own data.

This approach to fair value measurement has created much controversy in recent months. Critics argue that, in the current economic climate, focusing on market prices

requires an entity to value its assets at “fire-sale” prices even if it has no plans to dispose of them.

Market prices not always a reliable measure

Regardless of the merits of SFAS 157, the courts, as well as regulators, recognize that the current economic turmoil may require some adjustment to the usual valuation methods. Last fall, for example, the FASB and the SEC issued a joint statement advising companies that they can use internal assumptions, such as expected cash flows and appropriately risk-adjusted discount rates, to value securities when relevant market data is unavailable. Later, the FASB published FASB Staff Position (FSP) 157-3 to provide “guidance on how to determine the fair value of financial assets when the market for that asset is not active.”

The FSP explains that, in times of “market dislocation,” valuators shouldn’t automatically assume that market prices are determinative of fair value. Rather, valuations “may require the use of significant judgment about whether individual transactions are forced liquidations or distressed sales.”

Case in point

In *ASARCO v. Americas Mining Corp.*, the U.S. District Court for the Southern District of Texas found that market prices are sometimes unreliable. The case involved a claim by a Chapter 11 debtor that its parent corporation's purchase of the debtor's controlling interest in a Peruvian mining company was a fraudulent transfer.

The court addressed a number of issues regarding the valuation of the debtor's mining company stock. Although the parent company's expert believed that the best evidence of value was the stock's price on the day of the sale, the court observed that market price isn't always the best indicator of value.

In this case, even though the shares were traded on the New York Stock Exchange, its low trading volume and other factors overcame the usual presumption of market efficiency. The court concluded that, under these circumstances, a discounted cash-flow analysis was the most reliable method of valuing the stock.

What would a buyer do?

The principles discussed above aren't new. For years, the widely accepted definition of "fair market value" has been "the price at which property would change hands between a willing buyer and a willing seller when neither is compelled to buy or sell, and both have reasonable knowledge of the relevant facts."

It's reasonable to assume that a prospective buyer would consider the economy and other factors that affect the reliability of market prices in valuing a business. Similarly, valuators should consider these factors in determining the most appropriate valuation methods.

By shifting the emphasis — in some cases — from more objective, market-based approaches to more subjective, company-specific ones, it becomes evident that the economic downturn is having a significant impact on the business valuation process. ◆

LOOKING FOR THE SILVER LINING

Lately, most of the news about the economy has been bad, but there's a silver lining for people planning their estates. If your clients wish to make gifts of assets, including shares in a family business, to the younger generation, now may be an ideal time to do so.

Lower valuations of family businesses — as well as securities, real estate and other assets — allow them to give more while minimizing or even eliminating gift and estate taxes. The economic downturn has also created a liquidity crisis, which increases marketability discounts, reducing the value of interests in many family businesses and other closely held entities even further.

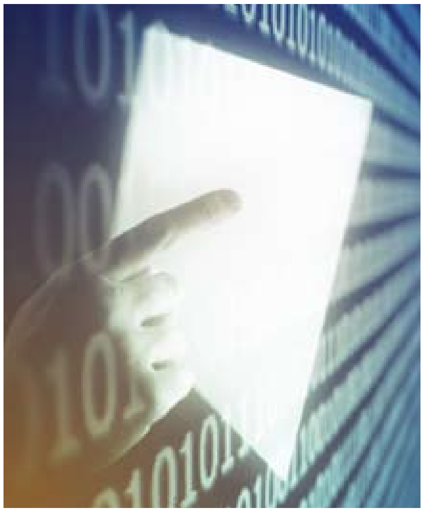
As you review these opportunities, keep in mind that, as the article on page 6 warns, lawmakers are considering a proposal that would limit the availability of valuation discounts for intrafamily transfers.

Forensic experts aid e-discovery

Widespread use of "electronically stored information" (ESI) has had a profound effect on the litigation process, particularly when it comes to discovery. One important difference is the sheer volume of ESI. Thus, Federal Rules of Civil Procedure (FRCP) 26(b)(2)(B) provides that a party need not produce ESI it "identifies as not reasonably accessible because of undue burden or cost," though the court may order discovery for good cause.

In many cases, the most effective method of identifying relevant documents is to conduct keyword searches of a party's ESI. To avoid disputes over the scope of electronic discovery, it's important to use searches that are designed to yield *relevant* evidence while minimizing the amount of *irrelevant* materials. A forensic expert who understands search techniques and is familiar with the types of documents being sought can be invaluable in this effort.

In *Ross v. Abercrombie & Fitch Co.*, the parties agreed to search the defendant's databases using 123 keywords. As a result, the defendant produced more than 1 million pages of documents.



Later, the plaintiff's counsel sent a letter listing "search term revisions," consisting of six search terms. The defendant interpreted the request to require a search of *only* those six terms, but in fact the plaintiff had intended the terms to be *in addition* to the previous 123. The parties agreed to run the search, which resulted in another 1-million-plus pages. The defendant refused to produce them, however, claiming undue burden and noting that the original search had produced many irrelevant documents.

The U.S. District Court for the Southern District of Ohio agreed with the defendant, finding that the plaintiff hadn't demonstrated that the cost of producing the documents was outweighed by their likely relevance. But the court suggested an alternative: An expert "conversant with both keyword searching and the types of documents produced to date" could help determine why the previous searches turned up so many irrelevant documents and help refine those searches to reduce the number of "hits" and increase the percentage of relevant documents. Parties who use this approach from the outset can design more effective discovery requests and perhaps avoid these sorts of disputes.

Of note: In an attempt to deal with the "information volume" problem, some courts have shifted the cost of reproducing information to the requesting party while other courts have tried to define the various types of electronic data media as accessible or inaccessible. ◆

It's not that easy: Determining how costs affect lost profits

Lost profits are a common measure of damages in commercial litigation, and in many cases they're the only form of recovery that can truly make a plaintiff whole. At the same time, establishing the amount of lost profits can be a challenge for lawyers and their financial experts because, by definition, it requires the parties to estimate what the plaintiff would have earned but for the defendant's alleged misconduct.

Projecting lost revenues with reasonable certainty is a difficult task, but determining the role that costs play in the calculation of lost profits can be equally complex.

Getting a fix on costs

The definition of profit is simple in theory: It's the difference between revenues and the costs incurred to produce those revenues. In a litigation context, however, it's not quite so straightforward.

Damages are usually measured by lost profits rather than lost revenues because, when a defendant's misconduct deprives a plaintiff of a business opportunity, it also causes the plaintiff to avoid the costs it would have incurred in pursuing that opportunity. Thus, awarding the plaintiff its lost revenues without subtracting avoided costs would give the plaintiff a windfall. It's also important to reduce lost profits by actual profits received by the plaintiff.

The question is, which costs are avoided? If a plaintiff's business is destroyed, the answer is relatively simple. Suppose that a plaintiff manufactures and sells 100,000 widgets per year for $10 each and that its total costs are $100,000 per year, or $1 per unit. If the defendant puts the plaintiff out of business, the plaintiff's lost profits are equal to its lost revenues (100,000 x $10 = $1 million) less its avoided costs ($100,000), or $900,000.

Now suppose that, instead of destroying the plaintiff's business, the defendant causes the plaintiff to lose 20,000 sales. It's tempting to conclude that the plaintiff's lost profits are equal to the lost revenues (20,000 x $10 = $200,000) less the costs associated with those revenues (20,000 x $1 = $20,000), or $180,000. But this oversimplified approach understates the plaintiff's lost profits.

The problem is that this approach assumes the cost of each lost sale is equal to the plaintiff's average cost-per-unit. That may be reasonable if the business is destroyed and *all* of the plaintiff's costs are avoided. But it fails to recognize that, if the plaintiff continues to do business, certain fixed costs are unavoidable.

Understanding the variables

To get an accurate picture of a plaintiff's lost profits, it's necessary to identify the *incremental* costs associated with lost sales. As a general rule, incremental costs are *variable* costs — that is, they increase or decrease in proportion to production volumes. These typically include direct costs — such as direct labor and raw materials — and may include certain indirect costs, such as shipping and handling expenses.

Incremental costs generally don't (but possibly could) include fixed costs, such as rent and other fixed overhead, which remain constant regardless of production volume. Certain costs that are ordinarily treated as fixed, however, may become variable over time if changes in production volume reach a certain level. These costs are commonly described as "semi-variable."

To get an accurate picture of a plaintiff's lost profits, it's necessary to identify the incremental *costs associated with lost sales.*

Administrative wages and benefits, for example, are usually considered to be fixed costs but might become variable under certain circumstances. Suppose our widget manufacturer employs three administrative workers. If it loses 20,000 sales, these costs probably wouldn't be affected. But if its sales are cut in half, the owner might lay off one of the workers.

In that case, the costs associated with that worker would be avoidable and, therefore, deducted from lost revenues in computing lost profits. Whether it would be reasonable to lay off an administrative employee depends on several factors, including the likelihood that the company will recover the lost sales, the amount of time it will take to recover those sales and the cost of hiring a replacement when needed.

In some cases, a plaintiff's incremental costs include those that would ordinarily be regarded as fixed. For example, if the plaintiff alleges that the defendant's wrongful conduct prevented it from entering a new line of business, it might be appropriate to reduce lost profits by the costs of equipment, factory and other fixed overhead that were avoided by abandoning the new venture.

There are several methods of calculating incremental costs using a company's own financial data, including direct cost assignment, account analysis and cost accounting analysis. If adequate records aren't available, it may be possible to estimate costs using statistical data from industry or government sources.

Don't cut corners

Profits are the difference between revenues and costs, and lost profits are the difference between lost revenues and avoided (or incremental) costs. Courts have been known to reject lost-profits calculations that fail to estimate and allocate costs properly, so it's critical for you and your financial experts to give equal attention to both sides of the equation.

To obtain greater confidence in estimated costs, financial experts may use several methods and compare the results to historical data, independent estimates or industry statistics. ◆

ESTATE PLANNING

ARE VALUATION DISCOUNTS IN DANGER?

Many estate planning techniques rely on valuation discounts to transfer wealth to family members at a minimal tax cost. Parents, for example, might transfer minority interests in a closely held business, a family limited partnership (FLP) or a family limited liability company (FLLC) to their children. Typically, these interests are entitled to valuation discounts for lack of control and lack of marketability, so that their value for gift and estate tax purposes is a fraction of the value of the underlying assets.

Because lawmakers have been concerned for years about potential abuses of valuation discounts, last year the Congressional Joint Committee on Taxation (JCT) proposed certain reforms that would limit the ability of families to take advantage of these discounts for transfer tax purposes under certain circumstances.

As of this writing, one bill has been introduced in Congress that would incorporate some of the JCT's recommendations. Among other things, H.R. 436 — the "Certain Estate Tax Relief Act of 2009" — would retain the federal estate tax in 2010 and beyond, freezing the estate tax exemption at its current level of $3.5 million. It would also impose two significant limitations on the availability of valuation discounts for transfer tax purposes:

1. **Nonbusiness assets.** The act would generally disallow valuation discounts for transfers of family limited partnership interests and other non-actively-traded interests to the extent the entity owns "nonbusiness assets," such as marketable securities. Nonbusiness assets held by the entity would be valued as if the transferor transferred those assets directly to the transferee. In addition, no discounts would be allowed in valuing a nonbusiness asset that consists of a 10%-or-more interest in *another* entity.

2. **Aggregation.** The act would prohibit minority interest valuation discounts for transfers of family limited partnership interests and other non-actively-traded interests if the transferee and certain family members control the entity.

As of this writing, it's uncertain whether the act will become law. If it does, it will have a big impact on gift and estate tax valuations. Check with a valuation professional for the latest information.

Valuation critical under new M&A rules

Sweeping changes to the accounting rules for mergers and acquisitions (M&A) will start affecting many companies that are closing deals this year. Statement of Financial Accounting Standards (SFAS) No. 141(R), *Business Combinations*, was issued by the Financial Accounting Standards Board (FASB) in late 2007, but it applies to deals closing on or after the first day of the first annual reporting period beginning after Dec. 15, 2008. Many of the changes prescribed in this 358-page document increase the importance of having accurate valuations.

Shift to a fair value approach

The purpose of the revised standard is to increase consistency and transparency in financial reporting and to clarify inconsistencies in previous pronouncements. To that end, the standard requires more fair value reporting. Here are a few of the key items that are affected:

Acquired assets and assumed liabilities. Purchasers are now required to recognize acquired assets and assumed liabilities at their acquisition-date fair values rather than at cost. In addition, any stock or other equity securities the purchaser issues as consideration must be measured by its fair value on the *closing date*, rather than the date the deal is announced, which was the previous practice.

Goodwill. Goodwill is calculated by totaling the fair value of: 1) the consideration for the purchase, 2) any noncontrolling interests in the target company, and 3) any equity interests in the target already held by the purchaser, and subtracting the net fair value of identifiable acquired assets and assumed liabilities. This is particularly significant in acquisitions of less than 100% of the target's stock because goodwill is measured based on the fair value of the entire company, not just the piece being acquired.

Contingent assets and liabilities. Purchasers are now required to record contractual contingencies (such as warranties) at their acquisition-date fair value. Noncontractual contingencies (such as lawsuits) are recorded at their acquisition-date fair value if it's more likely than not that they will result in an asset or liability.

This is a significant departure from previous rules, under which contingencies were recognized only if they were *probable and reasonably estimable*. Under the new rules, contingencies must be reevaluated in subsequent accounting periods and earnings adjusted as appropriate.

Contingent consideration. Purchasers are now required to recognize contingent consideration, such as an earnout provision, at its fair value on the acquisition date rather than waiting until after the contingency is settled. In subsequent accounting periods, changes in the estimated fair value of contingent consideration are recorded on the company's income statement.

Transaction costs. Transaction costs — such as legal, accounting and investment banking fees — are now expensed as incurred rather than capitalized as part of the purchase price. The immediate impact of these costs on earnings may cause some clients to become more fee-sensitive.

The role of business valuation

By shifting to a fair value approach to M&A accounting, SFAS 141(R) increases the need for valuations in connection with business combinations and makes the valuation process more complex.

Valuations are particularly important with regard to contingent assets and liabilities, contingent consideration, and other items that are subject to uncertainty. Although there's no way to eliminate this uncertainty, a thorough, well-reasoned valuation up front will minimize the earnings volatility that can result if frequent adjustments to fair value are required in the future. ◆