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AICPA Newsletter for Providers of Business Valuation & Litigation Services

CPA Expert

Fall 1997

FINDING INFORMATION ABOUT SALES OF CLOSELY HELD COMPANIES

Stephen J. Bravo, CPA, CBA, CFP, PFS, MST

A preferred approach for establishing the fair market value of a closely held business is to compare the business with similar companies that have been bought and sold. In the past, valuers had difficulty making such comparisons because they lacked information on the sale of such comparable businesses. Now, however, valuers of small businesses and professional practices can search several databases that provide the information they need.

Two databases have existed for several years, and two have come on the scene in the past two years promising to expand the amount and type of data available. The four databases are BizComps, Done Deals Data, the Institute of Business Appraisers (IBA) Market Database, and Pratt's Stats.

BIZCOMPS

BizComps is in its eighth year. Published by Asset Business Appraisal, San Diego, California, BizComps is an annual study of more than 2,540 businesses sold. Information is obtained from Certified Business Intermediaries (a designation given by the International Business Brokers Association based in Alexandria, Virginia).

BizComps
Asset Business Appraisal
P.O. Box 711777
San Diego, CA 92171
619-457-0366

BizComps comes in printed form or on diskette as a standalone Windows program developed by Wiley ValuSource. The printed version of BizComps 97 comes in three regional editions: Western, reporting 950 transactions; Central, reporting 850 transactions; and Eastern, reporting 740 transactions. The National Industrial Edition includes only larger manufacturing, wholesale/distribution, and service businesses sold nationwide and currently includes 350 sales transactions.

The information included in BizComps 97 is type of business, SIC code, date of sale, location of business, asking price, sale price and terms, annual gross revenues, seller's discretionary cash flow, inventory amount, furniture, fixtures, and equipment, and rent as a percent of sales. Information is presented in exhibits, each exhibit focusing on and presenting an analysis of a different characteristic of the business or the sale such as profitability, terms of sale, geographical area, size of the transaction, and type of business. The printed version of BizComps 97 is available for $98 per year for each edition.

The BizComps 97 Wiley ValuSource Program & Data Disk contains all the transactions included in the four printed editions. Data is accessed by SIC code, word search, sale size, and geographical area. Statistical analysis and graphing are also included. This version of BizComps 97 is available for $195 plus sales tax and shipping ($145 for existing subscribers).

DONE DEALS DATA

Done Deals Data, published by World M&A Network, was started in 1996. This database includes information on the sale of closely held public and private midrange companies ($1 million–$100 million). Information is

Contents

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obtained from various sources, but primarily from documents prepared by the companies themselves. The full product currently contains about 1,400 deals in 28 industries. About 200 transactions will be added per quarter. Therefore, it is expected that 2,200 deals will be reported next year.

Done Deals Data includes information on type of business, SIC code, company contacts, sales price, terms and sources of financing, seller financial statements, and ratios (when available), owner compensation, price-to-sales and price-to-earnings ratios, the names of the buyer or surviving merger partner with address, and phone number and the executive handling the transaction. Transactions are reported on an individual basis with no comparisons or statistical analysis performed.

> **Done Deals Data**
> **World M&A Network**
> **800-809-0666**

Done Deals Data comes on diskette and requires Windows 3.1 or Windows 95 plus 4 Mb RAM. It is possible to search the database by closing date, SIC industry, price, buyer, seller, and location. Done Deals Data will print out information by company, location, industry, or individual deal. You can subscribe to one industry for $95, which includes three quarterly updates, or all industries with three quarterly updates for $195. In addition, you can receive complete financials and transaction details upon request for $45 per deal.

IBA MARKET DATABASE

The Institute of Business Appraisers has maintained its database for more than fifteen years. It has recorded more than 11,500 transactions in more than 600 SIC code groups. Information for the database is obtained from IBA members and other sources. The information includes type of business, SIC code, sale price, annual gross sales, annual earnings (before owner compensation, interest, and taxes), owner compensation, and price-to-sales and price-to-earnings ratios.

> **IBA Market Database**
> **The Institute of Business Appraisers, Inc.**
> **P.O. Box 1447**
> **Boynton Beach, FL 33425**
> **561-732-3202**

This database is available free of charge to IBA members. Members submit information requests by SIC code and receive information by fax or mail.

PRATT'S STATS, PRIVATE BUSINESS SALE DATABASE

Pratt's Stats is the newest database with the first full release in September, 1997. It is published by Business Valuation Resources, Portland, Oregon. It has 400 transactions in its first release and plans to have 1,000 transactions within the year. Its data sources are the International Business Brokers Association, members of the Institute of Certified Business Counselors (Eugene, Oregon), the Professional Practice Valuation Study Group, and other sources.

> **Pratt's Stats**
> **Business Valuation Resources**
> **4475 S.W. Scholls Ferry Rd.,**
> **Suite 101**
> **Portland, OR 97225**
> **888-287-8258**

This database is the most ambitious in terms of the amount of data on business sales it will attempt to provide with more than fifty data points for each transaction. These include the SIC code and company type, the

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age of the entity, the number of employees, the amount of the down payment, the initiation date, the sale date, and the terms. The asset data provided includes cash, receivables, inventory, other current assets, real estate, fixed assets, intangibles, value of the noncompete agreement, employment agreements, and other noncurrent assets and liabilities assumed. The income statement line items include net sales, cost of goods sold, rent, owner compensation, noncash charges, other operating expenses, total operating expenses, interest expense, pretax income, taxes, and net income. In addition, Pratt's Stats provides the following ratios: price/sales, price/earnings, price/gross cash flow, price/EBT, price/EBIT, price/EBITDA, and price/discretionary earnings. Further inquiries are routinely made to verify the data, thereby improving its integrity and completeness.

Pratt's Stats has considerable flexibility in viewing and manipulating data. By selecting "View Data," the user can view all records or search results in either transaction or ratio formats. The user can also perform a search within this selection. Within the transaction format view, the user can also view multiples of the given transaction by selecting the "View Multiples" button. Search capabilities include searching according to these criteria: intermediary, company sold, income statement and balance sheet, and transaction. Each of these areas allows several different data fields to be specified. There are also capabilities to export spreadsheet programs and options for printing.

A subscription to Pratt's Stats includes four quarterly printouts and four quarterly diskettes. The diskettes can be obtained in format to be readable by Access 2, Access 7, or Access 8 or as a standalone database. The price is $375 per year.

COMPLEMENTARY DATABASES

The availability of these databases is a boon for valuers of small businesses who are looking for comparable transactions to be used in the valuation process as well as "sanity checks" at the conclusion of a valuation. BizComps and IBA have the largest number of transactions available. Done Deals Data and Pratt's Stats provide the most detail. BizComps does some analysis of the transactions while Done Deals Data provides additional background information, such as financial statements and transaction details of a specific deal on request. The IBA Market Database is available only in print or facsimile, but the other databases are available in electronic form providing search and print capabilities. Pratt's Stats also can be exported to a spreadsheet program. Although no one database is the complete answer, they all can contribute to the valuation process. CE

New Editors for *CPA Expert*

With this issue, we introduce and welcome James S. Rigby, Jr., CPA, and Michael J. Wagner, CPA, JD, as co-editors of *CPA Expert.* Mr. Rigby heads the Los Angeles office of The Financial Valuation Group. He is a nationally known speaker and author of several of the modules of the AICPA's program, Certificate of Educational Achievement in Business Valuation, and a member of the Accredited in Business Valuation (ABV) Examination Committee.

Mr. Wagner is a managing director with Putnam, Hayes and Bartlett, Palo Alto, California. He is a nationally known speaker and one of the editors of *Litigation Services Handbook: The Role of the Accountant as Expert* (New York: John Wiley & Sons, 2nd ed., 1995) and a former member of the AICPA Litigation and Dispute Resolution Services Subcommittee.

Together they will bring the practitioner's perspective to *CPA Expert* as it continues its quest to be the publication of choice for CPAs providing valuation and litigation services. Their participation will benefit our readers.

You can also help to ensure the high quality of *CPA Expert.* We encourage your feedback: Tell us what topics you want us to cover. Is there something you liked or disliked? As CPAs continue to serve their clients by providing business valuation and litigation services, *CPA Expert* will be in the forefront bringing you meaningful information to build your practice.

We thank you for your continued support.

David M. Bishop, ASA, CBA, FIBA is with American Business Appraisers, Inc., Portland, Oregon, and Frank C. Evans, CBA, CPA is with American Business Appraisers, Sharon, Pennsylvania.

AVOIDING A COMMON ERROR IN CALCULATING THE WEIGHTED AVERAGE COST OF CAPITAL

Using Multiple Iterations of the Weighted Average Cost of Capital to Confirm That the Debt and Equity Components Are at Fair Market Value

David M. Bishop, ASA, CBA, FIBA and Frank C. Evans, CPA, CBA

Practitioners preparing a business valuation want to feel confident that the value they have computed is reasonable and supportable. One way to ensure that is to avoid mechanical errors that can distort value. One error that valuers commonly make occurs when they compute a weighted average cost of capital (WACC) with an invested capital benefit stream. This article will explain how to avoid this potential error.

The debt-equity mix used to compute the WACC should include a debt component based on the fair market value of debt. For small to mid-sized companies, the balance sheet amount shown for interest-bearing debt is, generally speaking, not only the booked amount, but also the fair market value.

Conversely, the equity component of the

TABLE 1

Fundamental Data for the Case

I. A Typical Corporation—Fundamental Data From Financial Statements

Total assets		$2,200,000
Other liabilities		$200,000
Interest-bearing debt		800,000
Total liabilities		$1,000,000
Book Value Equity		$1,200,000
Debt-equity mix (at book values)		
Invested capital	$2,000,000	100%
Interest-bearing debt	800,000	40%
Book Value Equity	$1,200,000	60%

Net cash flow (NCF) available to invested capital (next year's):	$500,000
Forecasted long-term invested capital (NCF) growth rate:	3%

II. WACC (Based on Book Values) Applicable to Invested Capital

Applicable Rates

Equity discount rate	20%
Nominal borrowing rate	10%
Tax bracket	40%

Capital Structure (book value)

Debt	40%
Equity	60%

Computation of WACC

Component	Net Rate	Ratio	Contribution to WACC
Debt @ borrowing rate (1–.t)	6.0%	40%	2.4%
Equity	20.0%	60%	12.0%
WACC applicable to invested capital (based on book value)			14.4%

III. Single Period Capitalization Method: Net Cash Flow Available to Invested Capital Converted to a Value for Equity (amounts rounded)

Net cash flow available to invested capital	$500,000
WACC cap rate (14.4%–3.0%)	÷11.4%
Fair market value of invested capital	$4,400,000
Less interest-bearing debt	800,000
Indicated Fair Market Value of Equity	$3,600,000

WACC from the balance sheet is a booked amount that is seldom a reasonable surrogate for fair market value. The size of equity on the balance sheet is frequently influenced by tax planning and related factors that often reduce it. On the other hand, the fair market value of equity is largely dependent on investor expectations of risk and future performance. These expectations could create a high value regardless of the equity balance shown on the books. In the WACC computation, differences often lead to overestimating the less expensive debt component of the company's capital structure and, correspondingly, to underestimating the more expensive equity component. The resulting understated WACC leads to an overstatement of the value of the equity.

ILLUSTRATION

Table 1 on page 4 illustrates how the WACC should be refined to avoid the problem described above when appraising the value of the equity in a corporation using net cash flow available to invested capital.

DIFFERENCES IN VALUES OF EQUITY

The $1.2 million book value of equity in part I of table 1 was used to determine the 40-60 debt-equity weighting. As is seen in part III, however, the capitalization results in a market value of equity of $3.6 million. This distortion occurs because the equity portion at book value was undervalued, which, in turn, caused too large a portion of the WACC to be derived from the lower debt rate.

RECONCILING THE DIFFERENCES IN VALUE

The differences can be eliminated by performing iterations of the WACC based on the new debt-equity mix as illustrated in table 2.

CONTINUED DIFFERENCES IN VALUE

Once again, a difference exists. A fair market value of equity of $2.6 million was derived based on a debt-equity mix that used an equity value of $3.6 million. The distortion again results from an overvaluation of equity, but it can be reduced through additional iterations of the calculation as illustrated in table 3.

FINAL RECONCILIATION

The second iteration produced a value for equity that was substantially similar to the equity value used to calculate the WACC in

TABLE 2

Determining the Fair Market Value of Equity—First Iteration

I. Debt-Equity Mix

Invested Capital	4,400,000	100%
Debt	800,000	18%
Equity	3,600,000	82%

II. Computation of WACC

Component	Net Rate	Ratio	Contribution to WACC
Debt @ borrowing rate (1–.t)	6.0%	18%	1.1%
Equity	20.0%	82%	16.4%
WACC applicable to invested capital			17.5%

III. Single Period Capitalization Method: Net Cash Flow Available to Invested Capital Converted to a Value for Equity (amounts rounded)

Net cash flow available to invested capital	$500,000
WACC cap rate (17.5%–3.0%)	÷ 14.5%
Fair market value of invested capital	$3,400,000
Less interest-bearing debt	800,000
Indicated Fair Market Value of Equity	$2,600,000

TABLE 3

Determining the Fair Market Value of Equity—Second Iteration

I. Debt-Equity Mix

Invested Capital	3,400,000	100%
Debt	800,000	24%
Equity	2,600,000	76%

II. Computation of WACC

Component	Net Rate	Ratio	Contribution to WACC
Debt @ borrowing rate (1–.t)	6.0%	24%	1.4%
Equity	20.0%	76%	15.2%
WACC applicable to invested capital			16.6%

III. Single Period Capitalization Method: Net Cash Flow Available to Invested Capital Converted to a Value for Equity (amounts rounded)

Net cash flow available to invested capital	$500,000	
WACC cap rate (16.6%–3.0%)	÷ 13.6%	
Fair market value of invested capital	$3,700,000	100%
Less interest-bearing debt	800,000	22%
Indicated Fair Market Value of Equity	$2,900,000	78%

the second iteration. This eliminates the contradiction by producing a market value of equity that is based on a debt-equity weighting derived from a comparable equity value.

Of course, the result would be more comparable if the values and rates had not been rounded. Additional iterations of the calculation will narrow the gap further.

This process is appropriate even when the initial debt-equity mix is derived from an adjusted balance sheet in which the assets and liabilities are carried at fair market value. This is because the WACC being developed is for use in an income approach to valuation, which should function independently of factors considered when an asset approach is used (for example, in determining intangible asset values).

The valuer does not avoid the potential differences by using an industry debt-equity blend from a source such as RMA Annual Statement Studies. These industry debt-equity blends are most commonly derived from book-value balance sheets submitted to the source. Aggregating this data does not prevent the distortion. Therefore, the process of iterating the calculation illustrated should still be used in those valuations in which an industry blend is used for the debt-equity mix.

Business valuation can be a complex process. Consequently, people naturally question the accuracy and reliability of a conclusion of value. Therefore, it is up to the practitioner to prepare a thorough, incisive, and convincing report. Technical accuracy contributes to the desired credibility. For this reason, the valuer should be careful to calculate the WACC with the resulting market equity value being consistent with equity values in the WACC computation. CE

Expert Tools

ANOTHER INTERNET CHALLENGE: FINDING THE RIGHT INFORMATION FAST

Sorting Out the Internet Search Tools

Eva M. Lang, CPA

The Internet is certainly one of the most exciting tools available to the CPA expert. The Internet promises unlimited information at your fingertips. Unfortunately, the reality of having access to almost unlimited information is less appealing when you confront the effort involved in locating and extracting just the single fact you need for a report.

Literally hundreds of Internet search tools are available to assist you in plucking that fact from the informational morass. Some tools are more efficient than others. The tools generally fall into two broad categories: subject indices or keyword search engines.

SUBJECT INDICES

Subject indices, or directories, screen web pages for content and then assign the pages to categories, not unlike the directory structure used in the yellow pages. Yahoo (http://www.yahoo.com) was one of the first subject indices and is still one of the most popular. It lists sites in an outline form from the broadest to the narrowest categories. Subject indices such as Yahoo reduce, but by no means eliminate, the likelihood of irrelevant or duplicative search results.

A search on Yahoo for the term *Employee Stock Ownership Plans* can be done either by typing the key words into the Yahoo search window or by clicking through the layers of headings to arrive at the category "Business and Economy: Companies: Financial Services: Financing: Corporate Finance: Consulting: Employee Stock Ownership Plans: Organizations." This search results in six matches. The first two sites listed are the National Center for Employee Ownership, which Yahoo indicates has "information on ESOPs (employee stock ownership plans) and other forms of employee ownership", and the ESOP Association, "a national association of companies with employee stock ownership plans. The site includes information on the operation and management of ESOPs." The remaining four sites listed are the web sites of companies that do consulting work for ESOPs.

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About the Author:

Gary R. Trugman is a certified public accountant licensed in the states of New Jersey, New York, and Florida. He is a certified business appraiser, an accredited senior appraiser in business valuation, and a certified fraud examiner. He regularly serves as an expert witness in federal and state courts testifying on business valuation, matrimonial matters, business and economic damages, and other types of litigation matters.

Gary has and continues to serve on several committees for the AICPA, the NJ Society of CPAs, and International Board of Examiners to name a few. These committees range from business valuation to litigation services to ethics and discipline. He is a national lecturer on business valuation topics. He has developed, written and presented courses on business valuation.

Gary was born in New York and received his bachelor's degree from Bernard M. Baruch College of the City University of New York. He earned his master's degree from Lindenwood College in valuation sciences.

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KEYWORD SEARCH ENGINES

Keyword search engines roam the Internet, collecting web pages to build a collection of web documents. Keyword engines, such as Alta Vista (http://www.altavista.digital.com) or Webcrawler, search this amassed collection for terms that match your inquiry. The quality of the search results can be disappointing because unlike a subject index, no human has assessed the relevance of the results to your search term.

The quality of your search can be dramatically improved if it is structured to take advantage of the search capabilities of the site. For example, the keyword search engine Alta Vista defaults to "or" searching. That is, the search results will return every page that contains at least one of your search terms. A search using the key words *intellectual property* would produce a list of thousands of pages containing either the word *intellectual* or the word *property*. If, instead, you had used the phrase-match capability of Alta Vista to search for *"intellectual property"* as a term, the quality of your results would have been greatly improved.

If you search for the phrase *Employee Stock Ownership Plans* in Alta Vista, you get 862 matches. The first listing is a page on the website of a private company describing the consulting services it offers to ESOPs. The second is a page containing only a brief description of an ESOP on a bank's home page. The third listing is for a page on the topic of training on the National Center for Employee Ownership website. Other listings include SEC filings of companies with ESOPs and resumes of consultants who work with ESOPs. The first fifty matches contained no mention of the ESOP Association, the primary trade association for employee owned companies.

RIFLES AND SHOTGUNS

In addition to the two broad categories mentioned above, there are two other types of search tools: speciality indices and meta-indices. Specialty indices confine themselves to a particular topic or type of information. Examples include City.Net (http://city.net), a repository of information on cities around the world, and OKRA (http://okra.ucr.edu/okra), which searches only e-mail addresses.

SEARCHING MULTIPLE ENGINES

The opposite of the targeted focus of a speciality index is the scatter shot approach used by a meta-index. A meta-index is like a normal search index on steroids. Meta search tools allow the user to employ multiple search engines at once, combining the results into a single list. For example, SavvySearch (http://guaraldi.cs.colostate.edu:2000/form), an experimental search system, queries multiple Internet search engines simultaneously. SavvySearch will search twenty-five different search engines and indices for any or all of your query terms, and indicate the number of results desired from each search engine.

Users are often attracted to meta-indices by the implied promise of efficiency. Instead of typing your search terms into Alta Vista, then into Yahoo, and then into another search engine, you can type the terms just once in the meta-index. But a meta-index can be slow because it must wait for results from multiple servers. If one of the servers being queried has a glitch, it can hold up the entire search.

Of greater concern than the speed of access is the quality of the searching done by meta-indices. Most meta-search engines use the default query settings of the member engines. That means that if you ran your earlier search example *intellectual property* through SavvySearch, you would get the results of the default Alta Vista search, which would treat *intellectual* and *property* as separate terms.

Still, meta-indices are popular for "one stop shopping". Some of the more heavily used ones in addition to SavvySearch are Cyber 411 (http://www.cyber411.com) and All-in-one (http://www.albany.net/allinone).

SEARCH MANAGERS

The search tools I have discussed—subject indices, keyword search engines, specialty indices and meta-indices—are all available at no cost on the Internet. But users who are willing to pay have another search choice—search manager software. Search managers search faster and more efficiently than the free tools. They do this by helping you refine your query before beginning the search, and then by eliminating duplicate results and invalid links, and ranking your results. The search can be run in the background of your Internet session, or even overnight.

Continued on page 9

The quality of your search can be dramatically improved if it is structured to take advantage of the search capabilities of the site.

Eva M. Lang, CPA, a contributing editor, is vice president of Mercer Capital Management, Inc., Memphis, Tennessee and is a member of the AICPA Business Valuations and Appraisals Subcommittee.

RECENT COURT CASES

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WEBSITES

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CompanyLink
www.companylink.com
Information about 65,000 U.S. companies including competitors, operating units, news articles, and Universal Resource Locator (URL or web address). Can be searched by company name, industry, state, or ticker symbol.

Corporate Financials Online
www.cfonews.com
Public company news and filings.

Hoover's
www.hoovers.com
Descriptions and in-depth profiles of public and private companies with links to other sources of information. Access is free or fee-based.

KnowX
www.knowx.com
An Internet public record information service that provides access to information about a company's or individual's background, assets, and adverse filings. A fee is charged for recovered data.

Environmental Information
National Center for Environmental Publications and Information
epa.gov/ncephihom/index.html
Information about Environmental Protection Agency Superfund sites.

Fraud
Fraud Information Center
www.echotech.com/home.html
Fraud-related information

Legal Sites
AALLnet
www.aallnet.org/
The American Association of Law Libraries Online Information Service.

Cornell University Legal Information Institute
www.law.cornell.edu:80/lii.table.html
Hpertext versions of the U.S. Code and other documents, as well as Supreme Court decisions.

Emory University Law Library Reference Desk
www.law.emory.edu/LAW/refdesk/toc.html
Laws by country or subject, law journals, legal directories, and other reference material.

FedLaw
www.legal.gsa.gov
More than 1,400 hypertext connections to databases including the House of Representatives' *Internet Law Library* and Cornell University's *Legal Information Institute.*

Vacatur
www.andersonkill.com/vacatur.htm
Lists of vacated and depublished Court Opinions.

ANOTHER INTERNET CHALLENGE, *continued*

One of the most popular search managers is WebCompass (http://www.quarterdeck.com/qdeck/products/webcompass) by Quarterdeck. WebCompass, which sells for $49.95, uses a Topic Wizard to guide the user though the steps of setting up an advanced search. The search results can be saved, and WebCompass can be instructed to update old searches.

Another strong search manager is WebSeeker (http://www.ffg.com/seeker) from the ForeFront Group. WebSeeker allows you to choose from more than 100 search engines. WebSeeker removes duplicate pages and unavailable sites from your search results and indexes the results. It also sells for $49.95.

Rounding out our short list of search managers is FastFind (http://www.symantec.com/iff/index.html) developed by Symantec, makers of the popular contact manager program ACT! FastFind, also retailing for $49.95, is perhaps the easiest to use of the search managers mentioned here. Despite its ease of use, it still offers a number of powerful features, such as the option to confirm that all search results are active sites.

The CPA has access to several tools to help find that single elusive fact in the Internet haystack. CE

EXPERT *Opinion*

GUIDEPOSTS FOR PUNITIVE AWARDS

Excessive punitive damage awards have prompted proponents of tort reform to argue that punitive damages should be limited. The problem of drawing the line between excessive and reasonable damage awards was addressed by the U.S. Supreme Court in *BMW of North America vs. Gore* (No. 94-896; May 20, 1996). The Court outlined three "guideposts" for evaluating whether a punitive damage award is grossly excessive:

1. The degree to which the conduct was reprehensible.
2. The disparity between the harm suffered and the punitive award.
3. The difference between the punitive award and the civil penalties authorized in comparable cases.

The guideposts arose out of a dispute involving a repainted luxury car. Dr. Ira Gore Jr. bought a BMW sports sedan for $40,750. He detected no flaws in the paint finish of the car, but he engaged "Slick Finish" to make the car look "snazzier." Gore then learned that his BMW was repainted after being damaged by acid rain during shipment. BMW's policy was to sell, as new, cars damaged in shipment if the cost of repairing the damage was less than 3 percent of the suggested retail price.

The cost of repainting Gore's car was $600, so BMW sold him the car as new. Based on testimony that a repainted car was worth 10 percent less than other new cars, a jury awarded Gore actual damages of $4,000. The jury also awarded him punitive damages of $4 million.

The Alabama Supreme Court found that the jury calculated the punitive damages improperly and reduced the award to $2 million. BMW argued that the due process clause of the Fourteenth Amendment prohibits states from imposing "grossly excessive" punishments. Five of the nine U.S. Supreme Court justices agreed that a $2 million award based on a $600 paint job was grossly excessive.

Many lawyers assert that the guideposts do not provide much guidance for other courts on damage limits because they do not set out clear general rules. Some expect that plaintiffs in product liability suits will shop for state forums with a history of imposing large punitive penalties on out-of-state corporations. The result will be that appeals courts won't have time to review most of the cases.

Lawyers also see the *Gore* decision as a mixed message because it was handed down on a 5–4 vote. Furthermore, while the case was pending, the court vacated and remanded only four of sixteen punitive damages appeals on its writ calendar. The court let high punitive awards in the other cases stand.

Nevertheless, the *Gore* decision has had a clear impact on federal appellate courts and some impact on state appellate courts. The ruling has been invoked at least twenty times to reduce multimillion-dollar punitive awards, according to Theodore Boutrous, a partner in the Washington, D.C. office of Gibson, Dunn & Crutcher. Almost without

The expert's "decision to ignore the possibility of a public offering" added to the court's dissatisfaction with his report.

exception, federal courts have used the ruling to reduce punitive awards. Although several state supreme courts declined to use the ruling to reduce punitive awards in personal injury cases, other state courts have done so. Most notable among the latter is the Alabama Supreme Court, once reputed to be a favorite forum of plaintiffs. In *Ex parte Holland,* No. 19561631, the Alabama court opined:

> [I]t is no longer subject to doubt that there is a constitutional limit on the amount of punitive damages that may be awarded against a defendant for a tortious course of conduct affecting multiple claimants.

LESSONS LEARNED IN TAX COURT

CPA experts may want to take note of two Tax Court cases on valuation of closely held business interests for estate and gift tax purposes. In each case, the Court rejected the conclusion of value of the taxpayer's expert witness, citing their approaches to valuation or to developing and applying discounts. In both cases, the expert witnesses' testimony was given no weight at all.

ESTATE OF FREEMAN

Estate of Freeman v. Commissioner (T.C. Memo 1996-372) involved stock in Xilinx, a high technology start-up company. The decedent died holding a block of the common stock and an option to purchase additional shares. The estate's expert valued the shares at $1.05 each. The IRS set a fair market value of $4.20.

The Court questioned the estate's expert's use of "three approaches in valuing the shares: Capitalization of earnings, capitalization of revenues, and return on equity." In all of these approaches, a key feature is to identify publicly traded companies comparable to the subject firm. The Court observed "a discrepancy between [the expert's] earlier report and his expert testimony with respect to the identification of comparable companies." In the earlier report, which was attached to the estate tax return, the valuer identified eight comparable companies. However, in the report introduced to support his expert testimony in the Tax Court, the expert identified only one comparable company. During his oral testimony, he tried to explain the discrepancy and asked that his expert testimony be amended to make his earlier identification of comparable companies part of that testimony. The court opined:

> [His] oral testimony has raised for us serious doubts as to his understanding of the approaches to valuation that he selected. That, alone, is sufficient reason for us to reject the conclusions resulting from those approaches.

The court was also dissatisfied with the expert's report because "...in relying on his three approaches [he] ignored the dynamic state of the corporation.... [including] any recognition that future earnings and revenues might be different...." Specifically, the expert's "decision to ignore the possibility of a public offering" added to the court's dissatisfaction with his report.

MINORITY DISCOUNT REJECTED

The Court also rejected the estate's expert's application of a minority discount because of his method of developing it. The shares at issue in the case were not part of a controlling block. The taxpayer's expert asserted a 20 percent discount for lack of control, but only a 10 percent discount was allowed. The court explained why:

> [He] did not arrive at a value of the corporation and then try to determine the value of minority interest. He arrived at a market equivalent value for a share of the corporation and then multiplied [by the 20 percent discount] to arrive at the value of the share. We assume that, in valuing a single share of stock, the market would recognize the minority position of that share, and that no further minority discount would (or could) be demanded.

It would seem that the valuer would have fared better by first valuing the underlying business and then determining the discount.

ESTATE OF SCANLAN

The opinion rendered by the Court in *Estate of Arthur G. Scanlan v. Commissioner* (T.C. Memo 1996-331) repeats some of the themes introduced in *Estate of Freeman.* The Scanlan Court allowed subsequent buy-outs to influence its opinion of the value of the stock of Eatel, a telecommunications company, as the *Freeman* Court considered the potential of an IPO.

Another theme shared by the two cases is the impact of the estate expert's earlier report on the Court's opinion. In *Freeman,* the court faulted the expert for the "discrepancy between [his] earlier report and his expert testimony with respect to the identification of the comparable companies." In Scanlan, on the other hand, the Court faulted the expert for not considering changing—updating—his report.

In rejecting the expert's conclusion of value, the Scanlan Court underscored some key issues about the use of reports in providing expert testimony. The court rejected the expert's testimony because he—

> was unable to answer coherently many questions raised by the Court on conclusions reached in his reports, and he was unable to explain certain parts of the analysis contained in the reports. He arbitrarily applied a 35-percent marketability discount to the subject shares. He did not adequately discuss the publicly traded companies which he compared to Eatel, and he did not set forth their age, business, or product line with any specificity.

Furthermore, the expert failed to define the standard of value, which would be fair market value:

> He made no mention of a hypothetical buyer or a hypothetical seller, and, indeed, we read his expert report to be skewed in favor of a low value for the stock. CE

"SCOPE" LIMITATIONS IN FRAUD INVESTIGATION ENGAGEMENTS

TIP of the Issue

D. Edward Martin, CPA

What do CPAs do when clients—be they business enterprises or their legal counsel—engage them to assist in a fraud investigation and then try to place constraints on how they conduct their work?

For an audit of financial statements or other attestation engagements, the authoritative literature assists the practitioner in assessing the extent of the limitations on the scope of the work, the ways in which they might be remedied, and ultimately, the extent of his or her involvement (for example, an assurance report, a disclaimer of opinion, or withdrawal from the engagement). However, for a fraud investigation—the authoritative direction for which is founded on the AICPA's Code of Professional Conduct and the Statement on Standards for Consulting Services—the answers may not be so clear-cut.

The CPA may be engaged by a client to provide litigation consulting services involving a fraud investigation. Engaged as a consultant, expert witness, or both, the CPA must comply with standards related to professional competence, due professional care, and sufficient relevant data and other standards. In addition to addressing compliance issues, the CPA needs to be careful to avoid being made vulnerable as an expert witness and to minimize exposure to lawsuits for defamation, libel, wrongful termination, or other wrongful action complaints.

Risk exposure increases when restrictions are placed on the scope of the engagement. When a scope limitation is imminent, the first consideration is to weigh the character and the magnitude of the limitation. In most fraud-related engagements, the CPA discusses his or her role with the client "up front," so that the nature of the assignment and his or her ability to address it are fully outlined and understood. Usually a work plan is also designed early in the process, so that the full range of involvement and the types of procedures he or she is to perform are known to the architects of the investigation strategy.

Sometimes, however, as the CPA delves into the information made available, the approach or its results may not be what the client or its representatives had in mind. For example, if the CPA is to conduct a series of interviews to explore a particular line of inquiry, the data gathered can touch upon sensitive areas that may or may not be related to the thrust of the investigation. So, the client may block the CPA from proceeding further. Or the client simply may not permit the CPA access to certain key people or documents.

Then, the question is, "What effect will restrictions imposed by the client or its representatives have on my ability to gather information professionally or objectively?" A CPA

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Postscript to ADR Clauses in Engagement Letters

In response to the Tip of the Issue in *CPA Expert* (Summer 1997), "Using ADR Clauses to Manage Collections," a caveat comes from R. James Alerding, CPA, ASA, CVA, FABFE, director of Litigation Support and Valuation Services for Blue & Co., LLC, Indianapolis, Indiana. He cautions practitioners to clear the use of an ADR clause in a contract or engagement letter with their insurance carriers. Most insurers do not object to nonbinding forms of ADR, but some refuse to pay if arbitration or another binding form of ADR is used.

hired for a fraud investigation may well anticipate that certain avenues of inquiry may be closed, or at least diverted, for a variety of reasons—including some that are justified in particular situations. The CPA must be careful, for example, to avoid prematurely alerting persons suspected of wrongdoing to the examination of facts or records. In addition, employees and others who are not part of suspicious circumstances must frequently be shielded from any implications that they may somehow be involved.

Nonetheless, due professional care requires that the CPA continually assess whether his or her ability to craft a reasonable approach to the engagement, and to carry it out without undue interference, has been or will be compromised. If the CPA thinks that the work will be tainted by a restriction on what a professional must do in the circumstances, he or she should discuss the problem with the client and its representatives, to see what alternative approaches may be constructed. Failing in such an effort, there is little recourse for the CPA but to resign from the engagement. CE

Editor's Note: *Nonauthoritative guidance on conducting fraud investigations is provided in AICPA Consulting Services Practice Aid 97-1,* Fraud Investigations in Litigation and Dispute Resolution Services *(New York: AICPA, 1997). To order call the AICPA Order Department at 800-862-4272, select option no. 1, and ask for product no. 055001.*

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