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Valuation Perspectives

"Your Valuation Solution"

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PCAOB cites 'Big 4' auditors for failing to test intangibles

More evidence of the mounting pressures on auditors, issuers, and valuation professionals in the context of intangible assets: Pursuant to its Sarbanes-Oxley (2002) mandate, the Public Company Accounting Oversight Board (PCAOB) recently published its 2006 inspection of a "Big 4" audit and accounting firm, including a selected review of the Firm's audits of at least seven issuers of financial statements. For example, included among its findings:

> Issuer C. The issuer used the work of a valuation specialist to determine the fair value of certain assets acquired in a significant business combination. The fair value of these assets as determined by the specialist was approximately 18 percent less than their historical book value. The Firm did not perform procedures to test whether certain data the issuer provided to the valuation specialist were complete, accurate, and relevant. Similarly, the issuer used the valuation specialist to assist in its annual impairment test related to goodwill, and the Firm failed to test whether certain data the issuer provided to the valuation specialist were complete, accurate, and relevant.

The report also includes the Firm's response ("We have addressed the engagement-specific findings identified in the Report in a manner consistent with PCAOB auditing standards and [our] policies and procedures and, as previously communicated to the PCAOB staff…"). Similarly, a recent inspection of another Big 4 firm notes several deficiencies in the firm's audits of accounts receivable, goodwill impairment, and mortgage servicing rights. Note: A "substantial portion" of the Board's criticisms of any auditor and its subsequent dialogue with the firm occurs out of public view, unless the firm fails to make satisfactory progress within twelve months of the report. The complete archive of PCAOB reports is available at http://www.pcaobus.org/Inspections/Public_Reports/index.aspx#k.

Another announcement shows where auditors still need help

"We have heard some concern that auditors are not consistently effective at assessing risk and then responding appropriately," says Chief Auditor Thomas Ray, in a recent statement to PCAOB's Standing Advisory Group.

Additionally, our inspectors have observed some cases in which auditors did not respond appropriately to fraud risk factors, and some cases in which auditors appear to have approached their consideration of fraud as an isolated, mechanical process rather than an integral part of the audit.

The Board's 2008 standards-setting priorities will also include keeping an eye on fair value developments. "We have been evaluating the existing…standards on auditing estimates, auditing fair values, and using the work of specialists" to determine whether the Board needs to amend its standards and/or issue further guidance. While SFAS 157 will make some aspects obsolete, most of the PCAOB standards will still apply to the new accounting rules. Eventually, the Board will update its standards, Ray predicts, "some time in the next twelve months."

Finally, PCAOB has identified the top eleven inspection issues—including business combinations, asset impairment, and use of specialists—in its report on U.S. firms that perform fewer than 100 audits; see http://www.pcaob.org/News_and_Events/News/2007/10-22.aspx.

IRS Extends 409A Compliance Deadline to Next Year

The Treasury Department and the Internal Revenue Service (IRS) recently announced that taxpayers will have until December 31, 2008, to bring documents into compliance with the final non-qualified deferred compensation regulations under section 409A of the Internal Revenue Code. Last April, the Treasury and IRS issued final 409A regulations, which provide guidance regarding the requirements for deferral elections and payment timing under section 409A. Affected plans and arrangements were originally required to comply with the final regulations by December 31, 2007.

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IRS Notice 2007-78 extends the document compliance deadline for one year and provides additional limited transition relief. Importantly, the Notice does not postpone the effective date of the final regulations, which were already extended once, from January 1, 2007, to January 1, 2008). The Treasury and the IRS anticipate issuing further guidance "containing a limited voluntary compliance program that will permit taxpayers to correct certain unintentional operational violations of § 409A and thereby limit the amount of additional taxes due under § 409A," although the Notice does not indicate when to expect the additional guidance. A copy of the Notice is posted at www.irs.gov/pub/irs-drop/n-07-78.pdf.

Case Demonstrates How Courts Can Be Sticklers for Disclosure Deadlines

Estate of Perry, 2007 Tex. App. LEXIS 6465 (August 15, 2007)

The bulk of this probate case focuses on competing claims for the estate of Oma Bell Perry, who died in 2003 at the age of ninety, leaving her 7,000-acre Texas ranch to a home for needy children. Perry also carved out a portion to the Rangels, an aging couple who'd lived on the ranch and served as her longtime caretaker and housekeeper.

After lengthy litigation and a jury trial against the youth school and other parties for denying them the benefits of Perry's gifts, the Rangels appealed several issues, including the trial court's exclusion of the Rangels' expert appraisal witness. A stipulated case management order established a specific date (April 12, 2005) for disclosure of expert reports. The Rangels timely designated their expert witness, who would testify as to "the valuation of the Rangels' life estate in the [ranch], the monthly rental value of that property, and to other issues involved with the economic damages to the [Rangels]."

But they failed to meet the precise April deadline for disclosure of the expert report, furnishing copies to opposing counsel a little over three weeks later and filing a motion to extend the disclosure deadline at the same time. Counsel for one opposing party objected to the motion, claiming that the Rangels failed to show good cause for the late disclosure.

The Rangels' attorney submitted an affidavit explaining that he'd only become aware of the need for an expert appraisal just about a month before the deadline. After contacting the expert, the attorney believed the appraisal could be concluded within the remaining time. But two factors—the hospitalization of Mr. Rangel with a serious illness (brain cancer) and a language barrier—prevented the timely completion of the report. There was no failure of due diligence, the attorney argued, and as the trial was still over two months away, the opposing parties would suffer neither prejudice nor unfair surprise by admitting the report.

A draft is better than nothing

Nevertheless, the trial court denied the motion and precluded the expert appraiser from testifying at trial. Good cause for delaying docket deadlines does not exist simply because there is a lack of surprise to the other side, the judge ruled, or because counsel inadvertently misjudged the need for an appraiser.

Further, the evidence suggested that the expert was working on his report by the time of the April deadline and could have submitted a draft and amended it later. But given the failure to comply in any fashion with the disclosure time limits—and given the "wide latitude" afforded a trial court to maintain its trial docket and discovery orders—the trial court did not abuse its discretion in precluding the expert.

A 'Skeletal' Expert Report Complies with Federal Disclosure Rules

Audubon Veterinary Hosp., Inc. v. U.S. Fidelity & Guarantee Co., 2007 U.S. Dist. LEXIS 46301 (June 25, 2007)

In the wake of hurricane Katrina, a Louisiana veterinary hospital sued its insurance company for failing to fully compensate its business interruption losses. Discovery deadlines were set in the case, including disclosure of expert reports pursuant to Rule 26(a)(2)(B) of the Federal Rules of Civil Procedure (FRCP). The Rule clearly requires a "complete statement of all opinions to be expressed and the basis and reasons therefore," in addition to the underlying data and any exhibits that the expert will use.

The insurance company submitted a report that was not signed by the expert—it was not even clear that he'd written it. The report contained columns of figures without any conclusions or defined sources; it was also missing exhibits and a list of the expert's qualifications. The plaintiff moved to strike the expert's report for failing to comply with FRCP 26.

A strong argument for striking the report

The plaintiff presented "a strong argument for striking [the expert's] report," according to the federal district court. The "skeletal" report merely provided

notice that the insurance company intended to rely on its expert but otherwise failed to comply substantially with the federal rules.

However, "the Court must consider and weigh" many factors, including the insurance company's explanation, the prejudice to the plaintiffs of allowing the expert to testify, and the possibility that a continuance would "cure" the prejudice. But the expert's testimony was also "pivotal" to the insurance company's defense. The suit was "purely about the value of the plaintiff's business interruption insurance claim," for which the expert's report was "crucial."

After weighing these factors—and even though the insurance company provided no explanation—the Court declined to preclude the expert from providing evidence in the case. It gave the insurance company ten days to comply with FRCP 26 and ordered it to pay the costs of any deposition of the expert by the plaintiffs.

Court Decides Fate of 'Bad Facts' FLP in Divorce

Moser v. Moser, 2007 Ohio App. LEXIS 3723 (August 10, 2007)

In 1996, a married couple decided to form a family limited partnership (FLP) for estate planning purposes. Seven years later, they filed for divorce. After the trial court awarded the husband the FLP assets, he appealed, arguing that they were nonmarital property. The wife claimed that the trial court properly placed the FLP in the marital estate. Who was correct?

Inquiry is similar to estate tax cases

The characterization of property as either marital or separate is a factual inquiry. The trial court made the following findings regarding the FLP:

- The parties failed to sign the subscription pages at the time of the December 31, 1996, execution of the FLP.
- The wife never signed letters purporting to gift her interest in the FLP to the couple's children; and she testified that she'd never seen the letters purporting to gift the husband's interests (which he did sign).
- Six gift tax returns, dated 2001, purported to memorialize transfers of FLP interests to the couple's children on December 31, 1996, and January 1, 1997, but although she signed these partnership returns, the wife was unaware of their contents.
- The wife testified that she never intended to relinquish her ownership interest in the FLP until her death.
- The couple's 2001 personal tax returns did not reveal a specific percentage of ownership in the FLP.
- A tax accountant testified that the 1996 and early 1997 transfers were not actually completed until April 1997.
- The husband operated the FLP assets as his own, freely transferring funds between its related entities; he also continued to list FLP assets on his personal financial statements and receive distributions from them.
- Some FLP assets were acquired and/or subsidized with marital funds.
- At trial, the wife's expert testified that the husband operated the FLP entities as "alter egos" without apparent regard to fiduciary restraints.
- Additional witnesses characterized the husband as a "benevolent dictator" with regard to FLP assets, exerting considerable control over their cash flow.

Given these "bad facts" involving the formation and operation of the FLP, the trial court determined that the couple did not make valid gifts of their FLP to their children. The appeals court confirmed its characterization of the assets as marital property and its inclusion in the marital estate.

Characterization of Professional Goodwill under Continued Scrutiny

Hess v. Hess, 2007 Me. LEXIS 83 (July 5, 2007)

Currently, Maine is one of a handful of states that has yet to decide whether the goodwill of a professional practice constitutes marital property; and if so, whether there should be a further distinction between enterprise goodwill (marital) and personal or professional goodwill (nonmarital). The majority of U.S. jurisdictions (twenty-eight states) now make that distinction, while fifteen hold that both enterprise and personal goodwill are marital property. Four states preclude characterizing goodwill as property—and two, Alabama and Georgia, also have yet to decide.

Did Maine go with the rest of the nation?

During the Hess divorce, the trial court reviewed valuations of the husband's investment business submitted by both parties' experts. After considering the different opinions, the court expressly found the approach, methodology, and factors used by the wife's expert more reliable in establishing the fair market

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value of the investment firm at $328,000.

On appeal, the husband contended that the court erred by classifying the goodwill derived from the business as divisible marital property, because nearly all of that intangible value was personal--inextricably linked to his individual efforts, talents, etc. The husband urged the appellate court to adopt the distinction between enterprise and personal goodwill pursuant to May v. May (a 2003 decision by the West Virginia Supreme Court, oft-cited for its summary of national holdings and the majority rule).

The Supreme Judicial Court of Maine declined to rule on that discrete issue. Although the parties' experts disagreed on the ultimate value of the business, they both considered that a large portion of its value stemmed from goodwill, which could be quantified and transferred. (Presumably, neither expert attempted to distinguish enterprise from personal or professional goodwill.) The Court confirmed the trial court's ruling that the goodwill value of the business was an asset--transferable and divisible.

About Our Firm .....

Our firm has years of experience assisting attorneys and business owners in determining value for litigation support, gift and estate tax planning, marital dissolution, buy and sell agreements, and business sale purposes. Whether you are determining the fair market value of a closely held business interest for sale, gift, or estate planning, knowing what your company is worth is one of the most important financial aspects of being in business.

In addition, you may use a business valuation as a management and planning tool. Besides acting as a scorecard that will help management determine whether the company is gaining or losing value, the valuation provides a better understanding of the real profitability of the business. Whatever reason you have for needing a business valuation, John R. Janicek , CPA P.C. is prepared to assist you in being your valuation solution.

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