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ASSESSING UNSYSTEMATIC RISK

WARREN D. MILLER, MBA, CPA/ABV, CMA

Assessing risk is a key component in the valuation of privately-held businesses. When the valuation entity is a small company, accurate risk assessment is even more important because, despite recent IRS assertions¹ to the contrary, risk and company size usually move in opposite directions, as market data attest.

Size by itself, however, is virtually meaningless. The size of one company must always be put in the context of others in its industry. In a divorce-related engagement, for example, we performed a valuation of a dental laboratory grossing \$1.2 million and employing 18 people. Most CPAs would agree that such a company is small indeed, yet we learned from an industry survey that a lab that size was in the largest 12% of labs nationally.

Theory and practice in business valuation limit the treatment of risk assessment to rate-of-return data, ratio analysis, and lists of seemingly unrelated questions. Inexperienced appraisers, and even some with experience,

appear to believe that if they've done the ratio analysis and answered the questions on a published checklist, they're done with risk assessment. In actuality, they're just getting started.

Let's examine each of these areas.

RATE-OF-RETURN DATA

Rate of return (ROR) data are the *sine qua non* of risk assessment under the income approach. These data, which come from two sources, Ibbotson Associates and Grabowski & King, provide two key components (equity risk premium and size premium) used to derive discount-rate estimates using the capital asset pricing model or the build-up method.

The size premium is of particular importance in valuing small firms (annual revenues less than \$5 million). In the current edition of the Ibbotson data, the smallest firms—the so-called “tenth decile” firms—had an average capitalization, on a minority-marketable basis at September 30, 1998,² of \$57 million. The largest firm of the 190 in that decile, Rowe Furniture Corp., had a market capitalization of \$124 million.³

Roger Grabowski & David King of PricewaterhouseCoopers break their universe into 25 cohorts of four percentage points each. After creating initial groups with equal numbers of

Wanting to illustrate the idea that size must be in some industry context in a way that would make sense in a courtroom, we called researchers at the American Bar Association (ABA) in Chicago. The ABA said that, based on its membership statistics, a law firm would need 11 attorneys to be in the largest 12% of firms across the country. I put that in my report and later testified to it, finally silencing opposing counsel, who had said “Mr. Miller, this is not General Motors” so often that it sounded like Gregorian chant.

¹ See “Expert Witness for IRS Attacks Size Premium Part of Discount Rate” by Michael Annin and Bruce Johnson, *Shannon Pratt's Business Valuation Update*, July 1999 (Vol. 5, No. 7), pp. 1+.

² Figure computed from “Table 4-1: Size-Decile Portfolios of the NYSE, Size and Composition (1926-1998),” *Stocks, Bonds, Bills and Inflation: Valuation Edition 1999 Yearbook* (Chicago: Ibbotson Associates, 1999), p. 96.

³ Ibbotson, op. cit., “Table 4-2: Size-Decile Portfolios of the NYSE, Largest Company and Its Market Capitalization by Decile (September 30, 1998),” p. 97.

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NYSE firms, they add qualifying firms from the AmEx and NASDAQ. These firms tend to be smaller, of course; hence the within-group populations increase as size diminishes. The result is about 2,400 companies, more than 500 of which are in the 25th (smallest) cohort. Five hundred more are classified as "high financial risk" because of low performance or a weak balance sheet.

In addition to market value of equity (average market capitalization in the 25th group: \$40 million), Grabowski & King use seven other measures of size: market value of invested capital, book value of equity, five-year average net income, five-year average EBITDA, sales, number of employees, and total assets (the latter replaced book value of invested capital, effective with the year-end 1997 calculations).⁴ The size premiums are quite consistent across all eight measures. (For updated data: valuation.ibbotson.com/Risk_Premia/price_waterhouse.asp)

Most CPAs appraise equity in firms even smaller than those in Grabowski & King's 25th group. We need the size premium data, of course, but we need more.

RATIO ANALYSIS

None of us would argue against using ratio analysis. It's an essential tool. However, it has more limitations than most of us seem willing to concede. Ratios tell us only that a company is or isn't performing better than its peers. They tell us that there might be bad news or good news, but they don't tell us why.

The *why* is where the rubber meets the road in business valuation. If we don't understand why those ratios are better or worse than industry or guideline-company composites,

then we have not met the primary responsibility of the valuation professional: *to understand the nature of the business whose equity interest we're valuing*. How can we value a business if we don't understand how it works?

OTHER QUESTIONS

Various business valuation texts and reference resources contain lists of questions the appraiser should seek to answer. The questions themselves are not bad ones. However, they don't fit together in any kind of discernible and logical way. These quasi-incoherent "laundry lists," as I call them, appeal to a tick-and-tie mentality, but they are not much help for serious professionals.

Moreover, within the AICPA's Vision Project is a core value ("Attuned to Broad Business Issues") and a core competency ("Strategic and Critical Thinking Skills") that dovetail neatly with a key requirement of business valuation: to make judgments. For the CPA of tomorrow, few judgments will be based entirely on quantitative data. More and more, we will need to be able to interpret broad, qualitative information, think critically about it, and *make judgments*.

Laundry lists don't much help us towards that end. Instead, what we need is a framework that enables us to ask questions that will help us *understand* investment-specific, or unsystematic, risk. If we enhance our understanding of that risk, we increase our understanding of how a business functions in all its major aspects.

UNSYSTEMATIC RISK

The attributes that make a company different from others comprise its *unsystematic risk*.

⁴First published in *Business Valuation Review* (March 1995), Grabowski & King refined their approach in two subsequent articles: "New Evidence on Size Effects and Equity Returns" (September 1996) and "Size Effects and Equity Returns: An Update" (March 1997).

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to appraisers because it is an important predictor of profitability *at the level of the individual company*.

For instance, we were involved on the buy side of an acquisition in the industrial supply industry. Our client company was nearly a century old. Its management style was autocratic. Its computer system would have been the envy of the Smithsonian. Its knowledge of its major customers' buying habits was limited. It didn't even know what its gross margin was for each customer. Yet this company was highly profitable. Its executives raked in large bonuses, secure in the self-delusion that they were good at what they did. They weren't, but they didn't have to be.

Why? The explanation came from analyzing the underlying structure of the industry: The barriers to entry were high, the bargaining power of both suppliers and customers was low, and there was no threat of substitution. Moreover, rivalry was low. The biggest four competitors had more than 85% of the national market. By any measure, the market structure was an oligopoly.⁹ It was easy for a company to deliver superior returns in that industry: All the managers had to do was show up for work!

For its part, industry structure helps drive industry *conduct*. Here again, too many CPAs don't make the connection. Misled by the neoclassical microeconomic paradigm with its emphasis on cost, they do their analysis as if (a) all competition is price-based and, therefore, (b) cost is the sole consideration. In many industries, especially more concentrated ones, that's unlikely to be true. Moreover, though the Federal Trade Commission and the Department of Justice have worked hard (and quite successfully) to reduce industrial concentration nationally, economic research clearly shows that such concentration is common regionally and locally in a wide variety of industries.¹⁰

Why does conduct matter? The valuation professional must know how to analyze industry structure in order to recognize the implications of that structure for competitors' *likely* conduct in the marketplace. Conduct, in turn, bears directly on the performance of

the industry as a whole, as well as on that of each industry player.

The slightly modified McKinsey framework, in turn, helps us get at the issue of conduct (how firms compete). Its components offer a coherent approach to profiling each major competitor. We have read dozens of valuation reports that omitted any mention whatsoever of competitors, who they are, where they're strong, where they're vulnerable, how they compete, and so on. Does the conduct of rivals have an impact on valuation? Of course, it does. Conduct matters, as any CPA in a market with aggressive competitors can attest.

Company. At the company level, "the value chain"¹¹ consists of *primary activities* (inbound logistics, operations, outbound logistics, marketing and sales, service) and *support activities* (firm infrastructure, human resources management, technology development, procurement). Unlike the holistic approach of the McKinsey framework, this tool helps us analyze the various phases of the operating cycle of our client company *and how it does, or does not, create value for its customers*.

It is intuitive that valuation and value creation are correlated. Unfortunately, we've read many appraisals whose authors were clearly in the dark about how (or if) the company created value and, if it did, how sustainable any value-creating mechanisms might be. If valuation is prospective and, thereby, future-anticipating, then surely the presence or absence of value-creating mechanisms, as well as their sustainability, bears on that future and merits discussion in the report.

But there's more to the value chain than identifying sources of competitive advantage. To the appraiser, it provides a disciplined framework for understanding how the operations of any company work. Like any good theory, it doesn't tell us the answers; it gives us the questions. And if we're asking the right questions, the answers tend to take care of themselves. Such questions are the key to assessing unsystematic risk.

TOP-DOWN APPROACH

We have found that using a top-down approach to unsystematic risk assessment is

⁹ An oligopoly is "a market structure in which only a few sellers offer similar or identical products." *Principles of Economics* by N. Gregory Mankiw (Fort Worth: The Dryden Press, 1998), p. 338. Examples of such structures nationally include cigarette manufacturing and ready-to-eat breakfast cereals.

¹⁰ See *Industrial Market Structure and Economic Performance* (3rd Ed.) by F.M. Scherer & David Ross (Boston: Houghton Mifflin Company, 1990), pp. 79-81.

¹¹ From *Competitive Advantage: Creating and Sustaining Superior Performance* by Michael E. Porter (New York: The Free Press, 1985).

both effective and efficient. We start at the top of the risk ladder (macroenvironment) and begin zeroing in on our client company as we move down the rungs. There are few false starts this way, whereas working bottom-up tends to result in frequent re-starts. Working top-down also enables us to put the on-site management interviews where they ought to be: near the end of the valuation process, after we have learned the issues, researched competitors, and analyzed the quantitative aspects of the macroenvironment, the industry, and the company.

Later, when we're comfortable with our grasp of external forces, we use notes to formulate the non-routine questions we ask during our on-site visit. In addition to gathering vital "soft" information, the goal of these interviews is to uncover the "why" behind our ratio analysis and confirm our grasp of how the business works.

They also aim to assess the alignment, if any, of the strengths and weakness inside the company with the opportunities and threats beyond it. The overall thrust of this analytical approach is a disciplined assessment of unsystematic risk.

A RIGOROUS PROCESS

The analysis is qualitative, to be sure. But valuation professionals mislead themselves if they believe that it cannot also be rigorous. It can. Indeed, it must be. Rigor strengthens judgment, judgment enhances credibility, and credibility defines the expert. If valuation were simply a matter of push-a-button/get-a-number, clients wouldn't need us. It's not, and they do, yet too many CPA-appraisers we've met are uncomfortable making subjective judgments. Nonetheless, such judgments are the heart of what we do—when we do it right.

The challenge for us CPAs is to use the tools these models give us in order to enhance the quality of our valuation services. Future articles in this series will explain how to deploy the models to help assess the three levels of unsystematic risk. **CE**

Relying on materials provided to us as a result of our document request list as well as articles about the industry, its competitors, and our client company, we begin our valuation research broadly and bring our client company into focus slowly. In a small-company valuation in an industry unfamiliar to us, we read dozens of articles; the number varying according to the assignment. As we read, we note opportunities and threats at the macroenvironmental and industry levels. We also start filling in the different "Ss" of the McKinsey framework for each major competitor.

READERS REACT—CAN WE ALL BE WRONG?

TO THE EDITORS:

I am writing in response to the article entitled "Tax Effects of Discount Rates in Taxable Damage Awards" in the winter issue of *CPA Expert*. I applaud the valuable insight that such an article presents. However, while I do not take issue with the content of the article or the theory being presented, I do take issue with the manner of presentation in this publication. Here you have a theory that probably 90% of your membership is doing "wrong" (according to the article).

The work of a good percentage of that membership probably was reflecting an alternative methodology in their work in a court case going on at the time the article was presented. Wouldn't it have been better to present the materials as "an alternative way of doing things" (which it really is), rather than the only way?

Again, I applaud the article, but let's be careful to present theories and methodologies as just that, rather than as dogma.

—Nancy Fannon, CPA/ABV
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NOTE FROM THE EDITORS:

Ms. Fannon's letter presents us with the opportunity to clarify the position of *CPA Expert*. The purpose of *CPA Expert* is to present thoughts, ideas, methodologies, etc. relating to business valuation and litigation services issues of interest to our readers. We wish to emphasize that the articles presented are the opinions of the authors and should not be considered as "authoritative." As Ms. Fannon correctly points out, *Expert* articles often present a methodology that might be only one of multiple "correct" ways to arrive at a conclusion.

At the same time, we encourage readers to respond as Ms. Fannon did. Her point is well taken. We hope other readers will take the time to offer their comments on articles and ask questions they may have. *CPA Expert* offers a forum to valuation and litigation professionals to share ideas. **CE**



IRS HITS GRAND SLAM IN MAJOR SHUTOUT OF TAXPAYER

Tax Court Disallows Imputed Income Tax on S Corporation Earnings in Valuation Calculation; Denies Daubert Challenge

James R. Hitchner, CPA/ABV, and John Gilbert, CPA/ABV

In the case of *Walter L. Gross Jr., et ux., et al. v. Commissioner*; TC Memo 1999-254; No. 4460-97; No. 4469-97 (July 29, 1999), a gift tax case, the Tax Court agreed with the IRS that S corporation earnings should not be reduced by imputed taxes for determining discounted cash flow value. The court also sided with the IRS valuation expert in determining a 25% lack of marketability discount and 15.5% cost of equity capital. The IRS expert also survived a *Daubert* challenge of his valuation methodology.

The taxpayer claimed a gift value of \$5,680 per share while the IRS argued a \$10,910 per share value at trial. The Tax Court accepted the IRS value, resulting in a \$2,332,691 gift tax deficiency. This was a grand slam home run for the IRS, which prevailed on every major issue. The taxpayer and their experts were completely shutout.

The taxpayer was one of two family groups who each owned half of the outstanding shares of G&J Pepsi-Cola Bottlers, Inc., an S corporation. In 1992, the taxpayers made gifts of minority interests, each of which was less than 1% of the total shares outstanding. In the five years prior to the gift, S corporation net income (and, therefore, pre-tax income) for G&J averaged \$22,616,377 and distributions to shareholders averaged \$22,716,842. The company essentially paid out all its income as distributions.

TAXPAYER EXPERT

The taxpayer's expert used three separate methods to value the corporation: the "market price comparison method, the discounted future free cash-flow method, and valuation by capitalization of earnings." He gave greater weight to the last two methods in his conclusion of value, which was \$5,680 per share.

Discount For Lack of Marketability. The taxpayer's expert applied a 35% discount for

lack of marketability based on several studies of closely held and restricted securities. He stated that the average discount was approximately 30% for shares that would become marketable. He increased that amount to 35% because the G&J shares did not possess this marketability.

Cost of Capital. The taxpayer's expert arrived at the cost of equity capital as follows:

Risk-free rate of return	2.1%
Equity risk premium	7.0%
Company specific risk adjustment	1.0%
Small capitalization risk premium	4.8%
Inflation	4.0%
Cost of equity	19% (rounded)

At trial, the taxpayer's expert admitted that he used Ibbotson Associates data for the small company risk premium, although G&J did not fall into the Ibbotson definition of a small company.

Tax Affecting S Corporation Earnings. The taxpayer's expert testified that he was required under the Uniform Standards of Professional Appraisal Practice (USPAP) to follow recognized appraisal methods and techniques. He further testified that to comply with this standard, it was necessary to "tax affect" earnings of an S corporation. He imputed a 40% corporate tax rate in his calculations. The court called this a "fictitious tax burden." USPAP does not address tax affecting S corporations so this appears to be a broad generalization by the appraisal expert here.

IRS EXPERT

The IRS expert relied principally on a discounted cash flow method. To test the validity of his valuation conclusion, which was \$10,910 per share, he "considered the values of companies he thought comparable to G&J."

Discount For Lack of Marketability. The IRS expert applied a 25% discount for lack of marketability based on restricted stock studies and studies of companies that had initial public offerings. For the restricted stock studies, he concluded, "due to variations in characteristics of the observed firms and transac-

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that would have been payable had the Subchapter S election not been made.”

The court, however, interpreted the excerpt as “neither requiring tax affecting nor laying the basis for a claim of detrimental reliance.” Further, the court noted that the taxpayers “have failed to prove that they relied on either the guide or the handbook in any way” and the IRS was not stopped “from disregarding a fictitious tax when valuing an S corporation.”

The taxpayer’s expert presented a list of costs or trade-offs shareholders incur by electing S corporation status. The court dismissed the first argument—that G&J might not make actual distributions sufficient to cover the shareholders’ tax obligations—as an unreasonable assumption. Similarly, the court dismissed the second argument, that the S corporation might lose its favorable tax status. The court also dismissed the final argument that S corporations have a disadvantage in raising capital because it believed this argument was appropriately addressed in the cost of capital rather than in the tax affecting of earnings.

The taxpayer introduced a second expert as a rebuttal witness in the use of a discounted cash flow approach without tax affecting earnings. The Tax Court was unconvinced by this expert and was quite critical of his testimony and conclusions.

The court concluded, “the principal benefit that shareholders expect from an S corporation election is a reduction in the total tax burden imposed on the enterprise. The owners expect to save money, and we see no reason why that savings ought to be ignored as a matter of course in valuing the S corporation.”

CONTROVERSY AND CHALLENGE

Although the issue of taxes in S corporations is controversial, many practitioners, like the taxpayer’s experts here, also tax affect S corporation earnings at a hypothetical corporate tax rate. Some practitioners rely on various IRS publications including the *IRS Valuation Training for Appeals Officers Coursebook*, updated in 1998. The *Coursebook* unequivocally states that tax affecting S corporations at a corporate rate is the correct way to value these pass-through entities. The reverse presentation by the IRS here and the court’s quick dismissal of that position is therefore puzzling and disturbing.

The IRS expert calculated the cost of capital using traditional techniques, which is a rate after corporate taxes and before individual shareholder taxes. We suspect that this expert uses the exact same technique for valuing C corporations. If G&J were a C corporation and the expert were asked to value it as such, his conclusion of value would be significantly lower. As such, the position of the Court here is that an S Corporation election will greatly raise the value of a company. That just seems too simplistic and not “real world”.

As to *Daubert* challenges, be prepared for continuing applications and abuses. We suspect many practitioners will be inappropriately challenged in the future, and we hope this does not discourage the use of new techniques and ideas. The valuation profession has benefited from empirical research and new theories and applications over the last several years, which has resulted in better appraisals. However, be prepared. **CE**

EXPERT Opinion

TAX COURT REJECTS RESTRICTED STOCK AND PRE-IPO STUDIES

John Gilbert, CPA/ABV

In the *Estate of Frank A. Branson v. Commissioner*, TC Memo 1999-231, the Tax Court valued shares of two banks in the estate of a decedent who died November 9, 1991. The decedent owned 12,889 shares (12.89%) of

the Mendocino Savings Bank of Mendocino County, valued at \$181.50 per share by the estate, \$300 by the IRS, and \$276 by the court. The decedent also owned 500 shares (6.25%) of the Bank of Willets, valued at \$485 by the estate, \$850 by the IRS, and \$626 by the court. The court largely dis-

allowed the estate expert’s use of the restricted stock studies and pre-IPO studies widely used by appraisers. In this complicated case, the Tax Court once again proved it can be unpredictable.

ies. The judge also rejected the expert's assumptions under his piecemeal sales method.

Judge Parr concluded that the proper valuation was the \$307 actual sales price of the 1,111 shares sold one month before death reduced by a 10% blockage discount, resulting in a fair market value of \$276 per share.

BANK OF WILLITS

At the date of death, there were 48 Willits shareholders, with the decedent owning 6.25% of the outstanding shares. Two other family members owned 30.51% and 17.68%, respectively. Historically, very few Willits shares traded each year and from February 1980 until the valuation date, only 1,062 shares changed hands in 22 transactions. Willits board members made most of the sales either to Willits employees, other board members, or directors, or to induce qualified persons to become board members or officers. Most of the sellers, sold few shares, but the decedent sold 674 shares.

Historically, Willits shares traded at or near book value. The book value of the shares on July 31, 1992 was \$875 per share. The estate sold 500 shares on August 12, 1992 for \$425,000 (\$850 per share).

The IRS determined the value of the estate's shares was \$850, but at trial, reduced this to \$774 based on the estate's sale of all of its shares some nine months after the decedent's death. The estate asserted a \$485 share value, but conceded on brief to a range between \$485 and \$662 per share.

Of the post-death shares sold, 365 were purchased by a family member who already owned more than 30% of the outstanding shares. The court considered the relationship of the parties and the estate's need for funds to pay taxes and found the buyer "was an accommodating buyer, not a willing buyer." Consequently, the court did not rely on the share price in this sale, but did rely on the sale price of the remaining 135 shares.

The Estate's Expert. The estate used a different expert than Savings for the valuation. Noting that the expert's testimony at trial was "cryptic and unhelpful," the court relied

solely on his written report. The expert used the guideline companies approach and arrived at a value of \$882 per share on a marketable minority basis. He then applied a 45% discount for lack of marketability based on the "usual restricted stock and IPO studies." As in Savings, the judge rejected the use of these studies and gave little weight to that portion of the expert's opinion.

The IRS Expert. The IRS used the same expert to value Willets shares as it used to value Savings. The expert used the market and income approaches and considered actual sales to value the shares. He also used the same piecemeal-sales method he used in the Savings valuation. The expert used a 20% "liquidity discount" based on the restricted stock and pre-IPO studies, averaged the various results, and concluded a \$774 per share value.

Again, the judge found no persuasive evidence to rely on the restricted stock and pre-IPO studies. The expert had concluded that there was an established market for Willits stock, but the judge disagreed and accorded that part of the expert's conclusion little weight. The court rejected the value from the "piecemeal sales method" because that method results in the value to a particular borrower, not the fair market value.

Judge Parr concluded the best evidence of fair market value was the sale of 135 shares of the estate's stock at arm's length. Since the estate's sale was 2.9% less than book value, the court discounted the \$806 book value on the date of death to arrive at \$783 per share. The court then applied a 20% discount for blockage, resulting in a value of \$626 per share.

UNCERTAINTY CONTINUES

The outcome of the Branson case is another instance of the Tax Court's unpredictability. Even though the Tax Court many times previously has accepted restricted stock and pre-IPO studies, Judge Parr in this case did not. We valuers need to remind ourselves constantly that what our profession accepts as "given" still must be continually proven in Tax Court. **CE**

BEATING THE SEARCH ENGINES ODDS

Eva Lang, CPA, ASA

The wealth of information on the Internet and the software to access it that we call *search engines* have become important tools for CPAs providing litigation and valuation services. Yet the search for information can be frustrating to say the least. One explanation of the difficulty was offered by Drs. Steve Lawrence and C. Lee Giles of the NEC Research Institute of Princeton, New Jersey, in the July 8, 1999 issue of the scientific journal *Nature*.

Drs. Lawrence and Giles reported the results of their in-depth study of Internet search engines. Their study indicated that, while the vast majority of Internet users turn to search engines for help in finding information, not even the best search engine indexes more than 16% of the Internet. No wonder many users spend hours searching or give up in frustration without finding the information they need.

Can searchers beat the odds and begin to access that elusive 84% of the Web? Yes, if they are willing to be creative in their approach to searching and to employ some of the following tips:

▲ **Start with the best search tools.** There are thousands of search tools. No single tool can be classified as the “best,” but clearly some search tools are better than others. Lawrence and Giles found that Northern Light, Snap, and Alta Vista index approximately 16% of the Web, significantly more than the other popular search engines. In terms of freshness (the time a search engine takes to index changes made to pages) Alta Vista, Excite, and Hotbot are the most up-to-date search engines.

While Yahoo is not the largest search index, it does have actual human beings categorizing the sites, which makes the quality of the search results higher than the typical search engine that depends upon software to make cataloguing decisions.

If forced to limit myself to a single search engine, my choice would be Northern Light. Although not one of the most publicized search engines, Northern Light has steadily

improved and expanded its site over the last two years. Northern Light was named by *Nature* as the search engine that indexes the largest portion of the Web. This site offers help to users by sorting the results of searches into “custom search folders,” which contain all the results from a single site or type of site. However, the feature that sets Northern Light apart is its extensive collection of periodicals available for purchase on a per-article basis. The articles in the Northern Light “special collection” are not ordinarily accessible by search engines as they are part of the invisible Web discussed later in this article.

▲ **Communicate with your tools.** Once you have decided on a search tool to use, you can greatly increase your chances of success by understanding the search features offered by that site. For example, when using Northern Light to search on the phrase *employee stock option plans*, surround the phrase with quotation marks to instruct Northern Light to find only documents in which those four words appear in sequence. Without the quotation marks, Northern Light will search for Web pages containing those four words anywhere in the text, and return 125,654 hits. Instructing Northern Light to search for the phrase “*employee stock option plans*” culls the list to a much more manageable 11,010 hits. Adding more search terms will further refine the number of hits; for example, adding the term *valuation* to the search phrase narrows the search results from 11,010 to 1,855.

Many search engines offer two levels of searching: simple and advanced. The simple search typically works fine if the search term is a single, unique word. Otherwise, it is better to use the advanced features which may allow users to limit searches to parameters such as a date frame or publication source, or to use Boolean search language. Boolean searching allows users to use logical terms such as AND, OR, and NOT to define a search more precisely.

▲ **Use multiple search tools.** There is surprisingly little overlap between the major search engines, so searching multiple engines can greatly increase the percentage of the Web searched. You can search the major search engines individually and compare the results, but a quicker way is to use one of the many meta-engines available. Meta-engines will search multiple search engines simulta-



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Links to search tools mentioned in this article:

Northern Light: www.northernlight.com

Snap: www.snap.com

Alta Vista: www.altavista.com

Excite: www.excite.com

Hotbot: www.hotbot.com

Yahoo: www.yahoo.com

MetaCrawler:
www.go2net.com/search.html

Dogpile: www.dogpile.com

Debriefing: www.debriefing.com

Findlaw: www.findlaw.com

Speech and Transcript Center:
gwis2.circ.gwu.edu/~gprice/speech.htm

GovBot: eden.cs.umass.edu/Govbot

Lycos Invisible Web Catalog:
dir.lycos.com/Reference/Searchable_Databases

I-Sleuth: www.isleuth.com

Internet Resource Guide to Online Vendors: www.researchedge.com/irg/online2.html

neously and present results in an integrated format. Users can see at a glance which particular search engine returned the best results for a query without having to search each one individually.

Among the better meta-engines are MetaCrawler, Dogpile, and Debriefing. MetaCrawler sends your query to most of the major search engines and directories, and then combines the results in a single list, eliminating duplicates. Dogpile searches 26 major search sites, including newswires for current headlines and business news from several sources. Dogpile groups results from each search engine, with the descriptions provided by each site. Debriefing is a new meta-search engine that removes duplicates from results and determines the most relevant domain for your search, if it exists. Debriefing is my first choice for a meta-search as it is maintained by librarians who are constantly refining and upgrading the site. Most search engines are designed by programmers who may not be familiar with indexing and cataloguing.

While searching with multiple search engines will give you access to more of the Web, it is not the perfect solution. The *Nature* study found that the top 11 search engines combined cover only 42% of the Web.

▲ **Use specialty search tools.** Having the right tool for the job can make many processes go more smoothly. That applies to carpentry, cooking, and Internet searching. In recent years, there has been an explosion of specialty search engines that limit searches to specific topic areas such as law, business, and medicine. Three good examples of specialty engines are FindLaw, the Speech and Transcript Center, and GovBot.

FindLaw is similar to Yahoo! in layout and

operation. It is an excellent legal resource, cataloguing court cases, laws and regulations, law review articles, and many more legal source documents. FindLaw is my favorite starting point for legal research. Along with its companion engine, LawCrawler, it covers all the major legal resources.

The Speech and Transcript Center is a directory of links to a wide range of recorded speeches and transcripts from politicians, business people, and other notable people. An extensive business section links to speeches by major business leaders and transcripts from the major television and radio programs such as *Nightline*, *Washington Week in Review*, *NPR Marketplace*, and *CNN News Programming*.

GovBot allows users to search more than 800,000 Web pages from U.S. Government and Military sites with easy-to-use Boolean search forms. One of the advantages of using GovBot is that it knocks out many irrelevant Web sites since it searches only sites that have a .gov or .mil domain name.

▲ **Look for the invisible Web.** Even if you effectively used every search engine available, a large part of the Internet still would be inaccessible to you. Some types of sites are not indexed by search engines. This invisible Web includes information stored in databases, sites requiring registration, and information in non-html formats such as graphics, word processing, and spreadsheet files.

While users cannot access the invisible Web with a regular search engine, that does not mean that it is entirely off limits. There are now several sites with directories of these hidden sites including the Lycos Invisible Web Catalog and I-Sleuth.

The Lycos Invisible Web Catalog covers thousands of searchable databases, archives,

Resources for ADR

PRINT RESOURCES

Alternative Dispute Resolution Services: A Nonauthoritative Guide
New York: AICPA, 1999.

William C. Barrett, "The CPA as Mediator," *CPA Journal* (December 1998), pages 66-67.

Simeon H. Baum, "The ADR Act of 1998 Offers Opportunities for Accountants," *CPA Journal* (March 1999), pages 71-72.

Kevin D. Kreb, and Thomas K. Rioridan, "The Role of the CPA in Disputes Arising from Mergers and Acquisitions," *CPA Journal* (June 1998), pages 56-57.

David B. Lipsky, and Ronald L. Seiber, *The Appropriate Resolution of Corporate Disputes: A Report on the Growing Use of ADR by U.S. Corporations*, A Joint Initiative of

Cornell/PERC Institute on Conflict Resolution, Ithaca, New York: Cornell University, 1998.

Deborah Masucci, "The Role of CPAs as NASD Arbitrators," *CPA Journal* (June 1999), pages 66-67.

Philip Zimmerman, "In-House Dispute Resolution Programs," *CPA Journal* (March 1998), page 59.

"Who Uses Mediation and Arbitration, and Why?" *CPA Journal* (June 1999), page 66.

WORLD WIDE WEB RESOURCES
American Arbitration Association
Dispute Services Worldwide:
www.adr.org

CPR Institute for Dispute Resolution: www.adr.org

Society of Professionals in Dispute Resolution: www.spidr.org

and the NASD (National Association of Securities Dealers). Two places that provide this experience are community dispute resolution agencies such as small claims courts and local branches of the Better Business Bureau. You can obtain information about local opportunities for serving as a neutral from your state CPA society or bar association.

A neutral on a mediation assignment plays a more active role than the CPA in arbitration, whose role is judicial. Accordingly, compensation is higher in mediation. The usual range for experienced CPA mediators is \$150 to \$200 per hour. Rates may be higher when the mediator's skill and success rate are known to the parties.

ARBITRATION TRAINING AND ENGAGEMENTS

The major national ADR administrative organizations provide arbitration training. Although, the AAA currently is not seeking new applicants, the AICPA/AAA partnership allows for admitting a limited number of highly qualified CPAs.

Under its new rules for selecting arbitrators, the NASD is interested in recruiting more individuals with the financial business training CPAs possess. Applications may be obtained directly from the NASD by calling

212-858-8300. However, the AAA and the NASD each has its own training and other requirements for admission to their panels.

The AAA and the NASD generally pay fees for arbitration services on a per diem or half-day basis. Since AAA panel members are independent contractors, they can set their rates, which, if acceptable, are paid by the parties in arbitration. The fees range from \$700 to \$1,400 a day depending on the arbitrator's experience and background as evaluated by the parties. The NASD, on the other hand, directly pays fixed fees to its independent arbitrators. For a full day, panelists receive \$400, with the chair receiving an additional \$75.

The ADR practices of firms such as PricewaterhouseCoopers LLP include the arbitration of disputes arising from the acquisition or sale of a business. Well-known CPA firms establish such specialties, market the services, and charge normal consulting rates for them.

OTHER OPPORTUNITIES

CPA firms with consultants trained in ADR can provide risk management services to help clients avoid litigation and its high costs in legal fees and time lost. Corporations such as Paine Webber and the Equitable Life Insurance Society have saved substantial sums by using early intervention and mediation. Many small and medium-sized clients are unaware that they too can build such procedures into their business practices.

MARKETING ADR SERVICES

Attorneys are the usual gatekeepers who decide whether a dispute will go to ADR and who the neutrals will be. Those attorneys and judges involved in court-annexed ADR generally select as the neutrals people they know or

At the 1999 AICPA National Advanced Litigation Services Conference at the Grand Hyatt in Atlanta, Georgia, on October 18 and 19, a breakfast panel of representatives from the Academy of Family Mediators, the National Association of Securities Dealers, and the Society of Professionals in Dispute Resolution will discuss the topic "The Untapped Market for Experts in ADR: The CPA's Role in Arbitration and Mediation Proceedings." For more information about the conference, see page 20.

professionals who have similar credentials. Just as CPAs market their services to litigating attorneys, they also can market their services to attorneys who practice ADR.

Neutrals who are knowledgeable in certain topics are needed by the administration organizations. The AAA has many specialized panels for disputes in fields such as construction, real estate, and international trade, in which many CPAs have years of valuable experience. It also has commercial panels that deal with disputes in areas where almost all CPAs have experience. At present, however, the commercial panels are well stocked with other professionals with the necessary commercial experience.

The NASD prefers neutrals with experience in various phases of the securities industry. The more knowledgeable CPAs are of the industry's many phases, the more likely they are to be selected.

Courts hear many disputes involving partnerships, corporate ownership, intellectual property, estates and trusts, matrimonial finances and other areas in which CPAs are heavily involved. Finally, opportunities for neutrals in private practice exist in businesses that have disputes about the calculations in acquisitions or sales, in insurance companies faced with claims, and for parties making matrimonial financial arrangements.

In addition to the organizations named by Phil Zimmerman, many private organizations train mediators. You can find them listed in your local phone book or through your State Supreme Court. Many have been approved by such national organizations as the Society of Professionals in Dispute Resolution (SPIDR) and the Academy of Family Mediators. These groups provide mentor supervision for trainees, as well, which may be required for state certification.

In addition to mediation of commercial disputes, divorce mediation is a fertile area for CPA mediators. Well established and readily assimilated practice areas for CPAs are in divorce, workplace disputes related to human resources and operations, business valuation disputes, and bankruptcy.

—William C. Barrett, CPA
Richmond, Virginia

GAINING RECOGNITION

CPAs will continue to gain recognition as qualified neutrals because they have knowledge of and experience in the ADR process. This recognition will come as more CPA firms use ADR clauses in their own engagement letters and employment and other contracts as a means to settle disputes and as they encourage clients to do the same. Attorneys still will be the gatekeepers, but they will admit more CPAs to serve as neutrals. **CE**

GUIDELINES FOR GUARDING AGAINST DAUBERT CHALLENGES TO EXPERT TESTIMONY

Robert F. Reilly, CPA, ASA, CFA

In their "Expert Opinion" on page 6, James R. Huchner, CPA/ABV and John Gilbert, CPA/ABV comment on a Tax Court case in which the valuation expert survived a Daubert challenge to his expert testimony. They expect that many practitioners will be so challenged in the future and warn them to be prepared. In the following article, Robert Reilly, CPA, ASA, CFA, offers some guidelines that will help expert witnesses avoid such challenges.

CPAs who provide expert testimony should be aware of several recent court cases

that have applied and interpreted the *Daubert* guidelines with regard to expert testimony. The *Daubert* guidelines were articulated by the U.S. Supreme Court in *Daubert v. Merrell Dow Pharmaceuticals, Inc.* (113 S. Ct. 2786, 125 C. Ed., 2d 469 (1993)). These factors are applied by federal trial courts in their "gatekeeping" function of including—or excluding—expert testimony under the Federal Rules of Evidence Rule 702.

While the *Daubert* guidelines specifically apply in federal courts to expert testimony offered under Rule 702, CPAs should realize these federal guidelines may influence state and local trial courts as well.

The objective of the *Daubert* gatekeeping requirement is to ensure the reliability and relevancy of expert testimony. The trial court uses the *Daubert* factors to consider whether an expert witness, when basing testimony on



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professional studies or on personal experience, employs in the courtroom the same level of intellectual rigor that characterizes the practice of an expert in the relevant field. The *Daubert* case originally applied to scientific expert testimony, and the *Daubert* factors were used to help clarify what is science and what is “junk science.”

Several recent decisions by the Court of Appeals and the Supreme Court have concluded that the trial court’s gatekeeping inquiry into both relevance and reliability applies not only to scientific testimony, but also to all expert testimony. Accordingly, all practitioners should be aware of—and should attempt to comply with—these expert testimony guidelines.

THE DAUBERT FACTORS

Under Rule 702, trial judges have historically been the gatekeepers regarding the admission of expert evidence in federal cases. Traditionally, though, trial judges would rarely disqualify expert witnesses or exclude expert testimony. Rather, they would limit the areas in which the expert was allowed to offer testimony. They would allow witnesses to testify and then afford that testimony its “due weight” in their final deliberations. However, in *Daubert*, the Supreme Court articulated specific factors that trial judges should consider with regard to the admission of expert testimony.

In the *Daubert* case, a doctor testifying before the trial court presented a radical medical opinion. The opinion was unsupported by either the relevant professional literature, the medical research scientific standards, the recognized professional organizations, or any concurring medical research colleagues. With regard to the admission of this testimony, the questions that trial court faced were “Was the doctor truly a scientific expert or merely a ‘hired gun?’” and “Was the expert testimony based on medical expertise or on ‘junk science?’” With regard to the admissibility of expert testimony, the *Daubert* court wrestled with the following issues:

1. Whether the expert will be testifying as to scientific knowledge.
2. Whether the testimony based on scientific knowledge will assist the trier of fact in determining the ultimate issue.
3. Whether the proposed scientific

method has demonstrated validity or reliability.

The *Daubert* court applied four factors to determine the reliability of a particular expert’s scientific theory or technique:

1. *Testing*. Can the theory or technique be tested, or has it been tested?
2. *Peer review*. Has the theory been subject to peer review or publication, which aids in determining the validity of the method?
3. *Error rates*. Are there established standards to control the use of the technique?
4. *Acceptability*. Is the technique generally accepted in the relevant technical community?

In its decision, the Supreme Court noted that the *Daubert* factors should be applied flexibly, that the four factors were merely illustrative, and that other factors could argue in favor of testimony admissibility.

SONS OF DAUBERT

During the last several years, numerous trial courts have applied the *Daubert* factors. And, several appeals court decisions have sustained, expanded, and interpreted the *Daubert* factors. In *General Electric Co. v. Joiner*, 118 S. Ct. 512 139 C. Ed. 2d 208, the Supreme Court concluded that federal courts of appeals must apply an abuse-of-discretion standard when they review a trial court’s decision to admit or exclude expert testimony. That standard applies as much to the trial court’s decisions about how to determine reliability as to its ultimate conclusion, the Supreme Court ruled. The Supreme Court also concluded that whether the specific *Daubert* factors are appropriate measures of reliability in a particular case is a matter the law grants the trial judge broad latitude to determine—the same broad latitude that the trial judge enjoys with respect to his or her ultimate reliability determination.

Several trial courts (and appeals courts) have applied the *Daubert* factors to exclude valuation-related expert testimony. For example, in *Andrew J. Whelan, et al. v. Tyler Abell, et al.*, U.S. District Court, District of Columbia, civil action nos. 87-442 and 87-1763, the judge excluded the financial valuation expert testimony of a PricewaterhouseCoopers partner. The damages issue in the case involved the fair market value of the plaintiffs’ shares of a closely held corporation (Animated Playhouse Corporation). The plaintiffs’ expert

used only one valuation method (a discounted cash flow method) that relied on speculative financial projections. Applying the four *Daubert* factors to test the admission of the expert testimony under Rule 702, the District Court judge concluded: "The undue prejudice that would be caused to defendants by allowing the highly speculative testimony is clear. Accordingly, the court has excluded his testimony."

In *Frymire-Brinati v. KPMG Peat Marwick*, 3F. 3d 183 (7th Circuit, 1993), the Court of Appeals excluded the testimony of another CPA valuation expert. The damages issue in this case involved the fair market value of the plaintiff's partnership interests in a real estate development company. Again, the plaintiff's expert used only one valuation method (again, a discounted cash flow method) to value the subject partnership interests. Explaining its exclusion of the valuation-related expert testimony, the Court of Appeals specifically noted that the CPA valuation expert "conceded that he did not employ the methodology that experts in valuation find essential."

KUMHO TIRE COMPANY, LTD.

In *Kumho Tire Company, Ltd., et al. v. Patrick Carmichael, et al.*, (119 S. Ct. 1167 (March 23, 1999)), the Supreme Court clearly ruled that the *Daubert* factors—and the trial court's gatekeeping functions regarding the admission of expert testimony—apply not only to scientific experts, but also they apply to all "technical" or "other specialized" experts.

The *Kumho Tire* case involved personal injury damages and manufacturer's liability. When the tire on the vehicle driven by Patrick Carmichael blew out and the vehicle overturned, one passenger died and other passengers were injured. The plaintiffs claimed the tire was defective, based upon the deposition testimony of a tire-failure analyst. The expert opinion was based on a visual and tactile inspection of the tire.

The defendants moved to exclude the analyst's testimony at trial, on the ground that his methodology failed to satisfy Rule 702 of the Federal Rules of Evidence. Applying the four *Daubert* factors, the District Court judge excluded his testimony. The plaintiffs appealed.

The Eleventh Circuit reversed the District Court's Decision. The Court of Appeals held

that the District Court had erred as matter of law in its application of the four *Daubert* factors. The Court of Appeals ruled that *Daubert* was limited only to a scientific context and that the *Daubert* factors could not be applied to Carson's testimony because that testimony is characterized as "skill-or-experience-based." The defendants appealed.

Writing for the Supreme Court in the *Kumho Tire* opinion, Justice Beyer states unambiguously,

"The *Daubert* 'gatekeeping' obligation applies not only to 'scientific' testimony, but to all expert testimony. Rule 702 does not distinguish between 'scientific' knowledge and 'technical' and 'other specialized' knowledge, but makes it clear that any such knowledge might be the subject of expert testimony. It is the Rule's word 'knowledge' not the words (like 'scientific') that modify that word that establishes a standard of evidentiary reliability."

Explaining the Supreme Court's agreement with the trial court's decision, Justice Beyer concluded,

"In *Daubert*, this Court held that Federal Rule of Evidence 702 imposes a special obligation upon a trial judge to 'ensure that any and all scientific testimony...is not only relevant but reliable.' The initial question before us is whether this basic gatekeeping obligation applies only to 'scientific' testimony or to all expert testimony. We, like the parties, believe that it applies to all expert testimony."

Accordingly, in *Kumho Tire*, the Supreme Court concurred with the trial court and excluded the tire expert's testimony based on an application of the *Daubert* factors.

TARGET MARKET PUBLISHING

In *Target Market Publishing, Inc. v. ADVO, Inc.*, 136 F. 3d. 1139, 1998 U.S. App. Lexis 2412, the Seventh Circuit decided the appeal of another case involving the exclusion of testimony by a CPA valuation expert witness. In this case, the Court of Appeals decisively concluded that the *Daubert* factors apply to valuation and economic damages testimony.

In this case, Target entered into a one-year contract with ADVO to prepare and distribute a direct mail advertising publication called *Select Auto*. The project involved selling automobile dealers exclusive advertising rights at a flat rate in the monthly publication. The two companies were to share equally any profits earned from the *Select Auto* enterprise.

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Several recent decisions...have concluded that the trial court's gatekeeping inquiry into both relevance and reliability applies not only to scientific testimony, but also to all expert testimony.

Complying with *Daubert* Guidelines

Compliance with the following guidelines cannot assure a trial court's acceptance of the CPA's testimony. However, these guidelines can help the CPA expert to improve his or her work product and to comply with the standard practice of an expert in valuation and economic damages.

1. *Know the relevant professional standards.* The CPA should be aware of—and be familiar with—the promulgated professional standards applicable to the analysis. These standards may be promulgated by government or regulatory agencies (for example, the Uniform Standards of Professional Appraisal Practice [USPAP]), or they may be issued by professional organizations or societies (for example, the AICPA).

2. *Apply the relevant professional standards.* Whenever possible, the CPA should apply the recognized, promulgated professional standards to the analytical work product and to the proffered expert testimony. When the CPA cannot comply with professional standards (due to data limitations, contractual agreement, or some other reason), that fact normally should be disclosed in the analysis work product and expert testimony. Similarly, when the CPA does comply with all relevant professional standards, that fact should be attested to in the analysis work product and expert testimony.

3. *Know the relevant professional literature.* Professionals in any discipline generally know what the most authoritative books and journals (whether refereed or popular) are in their field. Along these lines, experts in valuation and economic damages may not be expected to agree with all of the leading books and periodicals, but they would be expected to recognize them. This is because leading publications will generally discuss the recognized theories, procedures, and standards within a particular discipline or profession.

4. *Know the relevant professional organizations.* Professionals in any discipline generally know which are the recognized organizations in their profession. Within a given profession, a practitioner may not be expected to join every single institute or society. That can be duplicative and cost prohibitive. Practitioners should be

familiar, however, with the names of the leading professional organizations in their discipline. This is particularly true with regard to organizations or associations that grant professional designations, promulgate professional standards, or publish authoritative journals.

5. *Use generally accepted analytical methods.* There is usually a reason why some analytical methods and procedures become generally accepted over time—and others do not. The CPA should be able to distinguish between the generally accepted methods within the discipline and those that are not generally accepted. Normally, the CPA should use the profession's recognized methods and procedures. In such cases, the CPA should assert such compliance with generally accepted methodology. Occasionally, a CPA may be unable to use the discipline's recognized methods and procedures. This may occur with regard to a unique set of facts and circumstances. When the CPA has to develop a *de novo* methodology, that departure from the discipline's generally accepted practices should be disclosed—and the reason for the departure explained—in the analytical work product and in the expert testimony.

6. *Use multiple analytical methods.* Whenever possible, the CPA should use multiple methods in a valuation or economic damages engagement. The use of multiple methods allows for mutually supportive evidence upon which to reach an analytical conclusion and helps to identify aberrations that lead to an "outlier" conclusion. The use of multiple analytical methods also mitigates the perception that the CPA has selected one particular procedure that would result in a biased conclusion. Of course, the methods should be generally used by experts in the discipline.

7. *Synthesize the conclusions of the multiple analytical methods.* In virtually any type of quantitative or qualitative analysis, the use of multiple methods also allows for a reconciliation and synthesis of alternative indications in the process of deriving a final conclusion. This synthesis should include an assessment of the relative strengths and weaknesses of the alternative methods used and some form of weighting or reconciliation (whether implicit or explicit) of the results of the alternative methods used. This synthesis

should also involve some explanation (or justification) of why certain analytical methods were selected and others were rejected.

8. *Disclose all significant analytical assumptions and variables.* In virtually all analyses (especially valuation and economic damages analyses), there are implicit and explicit assumptions, variables, and conditions. Some assumptions may be relatively insignificant or insensitive (that is, a material change in the assumption will not materially affect the analytical conclusion). Some of the assumptions, however, may be significant and sensitive. Generally, the CPA should identify, quantify (if possible), and justify the most important analytical assumptions and variables. While this disclosure may not always occur in the analytical work product (for example, where the client has requested a conclusory opinion only), this disclosure is usually helpful to the trier of fact during expert testimony.

9. *Subject the analysis to peer review.* Most CPAs agree that the process of peer review (usually performed by a professional colleague within the analyst's firm) is extremely beneficial. The peer review (some firms call it a professional standards review) often identifies analytical weaknesses, internal inconsistencies, mathematical errors, flaws in logic, or disclosure inadequacies. Obviously, this peer review should occur after the analysis is completed but before the expert testimony is presented. Such a peer review should give the CPA confidence to assure the trier of fact that there are no logical, methodological, or mathematical flaws in the analysis.

10. *Test the analysis—and the conclusion—for reasonableness.* Prior to offering expert testimony, the CPA should assess the overall acceptability of the analysis—and of the conclusion. The CPA should consider the relevance of the methods selected and the data used and the overall reasonableness of all assumptions and projections in comparison to the actual history (if any) of the particular fact set. And, by any logical or empirical standards, the CPA should assess the overall reasonableness of the indicated results. If the CPA is not convinced of the reasonableness of the analysis, it is likely the trier of fact will not be convinced of the reasonableness of his or her expert testimony.

In April 1994, Target brought suit against ADVO, claiming breach of contract and breach of fiduciary duty. After the close of discovery, ADVO filed a motion for summary judgment maintaining Target could not prove its claim that it had sustained damages of at least \$75,000 as a result of the failed *Select Auto* project.

In its response to the motion for summary judgment, Target relied upon an expert report prepared by a CPA from Deloitte & Touche. ADVO replied that the “report is pure speculation based on utterly implausible assumptions and unreliable methodology.” The District Court agreed with ADVO, disregarded the expert’s report, and granted summary judgment for ADVO. Target appealed.

The Court of Appeals had to decide whether the District Court had properly excluded the report of the plaintiff’s expert under the *Daubert* factors as part of the trial court’s gatekeeping function. In concluding that the trial court had properly applied the *Daubert* standard, the Court of Appeals made an interesting analogy

“If, for instance, an expert who was well qualified as an astronomer offered to testify based on lengthy and careful observation that the sun revolves around the earth, a court would not be obliged to submit the testimony to the jury. The Supreme Court recently upheld a district court’s decision to exclude expert testimony on the ground that it ‘did not rise above “subjective belief or unsupported speculation.”’” (See *General Electric Co. v. Joiner*.)

Further explaining its agreement with the trial court’s decision, the Appeals Court continued

“We note first that the Supreme Court has recently resolved any ambiguities concerning the standard of review that the courts of appeals are to apply in reviewing a district court’s evidentiary rulings under *Daubert*. The standard of review is the same one applied to other evidentiary rulings—that is, abuse of discretion. Applying the abuse of discretion standard, the Supreme Court affirmed, stating that ‘nothing in either *Daubert* or the Federal Rules of Evidence requires a district court to admit opinion evidence which is connected to existing data only by the *ipse dixit* of the expert. A court may conclude that there is simply too great an analytical gap between the data and the opinion proffered.’” (See *General Electric Co. v. Joiner*.)

The Appeals Court concluded that the

District Court did not abuse its discretion in applying the *Daubert* factors to exclude the expert report of the CPA valuation expert.

THE CPA’S CONSIDERATION OF THE DAUBERT STANDARD

There are no hard and fast specific rules that a CPA must comply with in order to ensure acceptance under the *Daubert* expert testimony standard. Rather, there is a general litmus test. As described in the Supreme Court’s original decision in *Daubert*, the general litmus test is: “What is the standard practice of an expert in the relevant field?” The question remains pretty much the same for valuation and economic damages expert testimony: What is the standard practice of an expert in this particular analytic discipline?

Based on a synthesis of the various courts’ decisions in the several “sons of *Daubert*” cases, a CPA should consider the suggested guidelines (see page 18) when presenting valuation and economic damages expert testimony.

GOING FORWARD

It is clear that trial courts and courts of appeal are broadly applying—and broadly interpreting—the general *Daubert* expert testimony principles. And, it is also clear that the courts have concluded that the *Daubert* principles apply to all expert matters that fall within the Federal Rules of Evidence Rule 702, which, with respect to all matters, “establishes a standard of evidentiary reliability.”

Accordingly, valuation and economic damages experts who provide expert testimony should be aware of—and should comply with—the four *Daubert* factors. The federal courts can, and will, broadly apply the *Daubert* factors (with appropriate modifications) to decide the acceptance or rejection of valuation-related and economic damages-related expert testimony.

Valuation and economic damages experts should also be aware that state and local trial courts may also be influenced by *Daubert* factors. Accordingly, CPAs should carefully consider the four *Daubert* factors when presenting valuation or economic damages testimony before all triers of fact. **CE**

FYI...

UPCOMING CONFERENCES

Two upcoming AICPA conferences offer CPA experts opportunities to further their technical knowledge of business valuation and litigation services.

LITIGATION SERVICES

Technical and practice management knowledge and skills will be covered in the 1999 AICPA National Advanced Litigation Services Conference at the Grand Hyatt in Atlanta, Georgia, on October 18 and 19. The sessions cover three areas:

▲ Specialty areas, including accounting malpractice, construction litigation, and patent infringement and damages.

▲ Technology, including electronic recovery and discovery, using research to enhance results in litigation services.

▲ Technical issues, including business damages in commercial litigation; the emerging practice impediments and potential testimony limitations that could lead to charges of unauthorized practice of law; and multiple regression in estimating lost profits.

The recommended CPE credit is 17 hours.

On the afternoon of October 17, two optional sessions will be offered concurrently. One session will cover bankruptcy issues related to bankruptcy valuations, expert witnessing, and investigation of avoidance actions. The other will cover emerging issues in divorce, tax issues in high-income divorces, and forensic accounting for divorce. Each session is recommended for 4 CPE credit hours.

BUSINESS VALUATION

The AICPA National Business Valuation Conference offers a full program to participants in three tracks—advanced, basic, and litigator. Scheduled for December 5, 6, and 7, 1999 at the newly opened Venetian in Las Vegas, Nevada, the general conference sessions will cover a view of business valuation for the U.S. Tax Court, a current court case update, and ethics and profits in business valuation. There will also be a technology exposition allowing participants to access innovative business valuation software.

The concurrent sessions offer three separate tracks:

▲ Advanced, covering start-ups, valuing restricted stock options, working with

advanced wealth transfer techniques, the 10 most frequent errors of business appraisers (from a matrimonial lawyer's perspective, Chapter 14, key aspects of bankruptcy in the application of business valuation, and intellectual property valuation and damages.

▲ Basic, covering creating an effective valuation report, small business issues, building a business valuation library, liability issues, marketing, discounts and premiums, and family limited partnerships.

▲ Litigator, including advanced training on expert witness testimony, insurance and damages issues, valuation in a divorce context, the implications of the *Daubert* and *Kumho Tire* cases, financial investigation of a business being valued, divorce taxation, and Chapter 14.

In addition, in the late afternoon of Saturday, December 4, a three-hour optional session will provide insights into valuing a medical practice. The recommended CPE credit for the entire conference is 21 hours.

For information about any of these conferences, call 888-777-7077.

FRAUD INDEX

A new Web site offers breaking news on fraud: www.fraudindex.com/fraudindex/fraudnews.html. At this site, you can find news coverage on fraud associated with banks, credit cards, charities, checks, health care, identity, insurance, the Internet, mail, phones, securities (including breaking news on class action law suits) and Y2K. The site is a service of FraudIndex, Rye, New York. 