The Financial Valuation Group

Forensic Accounting, Business Valuation and Consulting

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Testimony of Valuation Experts

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At a recent conference of the American Institute of Certified Public Accountants, I participated in a panel discussion on valuation expert witnesses. The panel consisted of attorney Bill Dolan (Jones Day) and CPAs Neil Beaton (Grant Thornton), Harold Martin (Keiter) as moderator, and myself. The following are comments from that session.

OBJECTIVES OF CROSS-EXAMINATION

From the perspective of opposing attorneys, the objective of cross-examination of experts is to poke holes in their opinion or credibility or both. Opposing attorneys obviously want to strengthen their case. One way to do this is by weakening the other side's case. At trial, attorneys attempt to expose flaws in facts or methods used or not used by experts, flaws in reasoning, or bias. In valuation, this might be done in attacking methodology and inputs used in models.

From the perspective of testifying experts, the basic objective is to get through cross-examination without being dealt a fatal blow. Practically speaking, any seasoned attorney is likely to score some points when cross examining any expert. The hoped-for outcome is that the attorney doesn't run up the score. Perhaps the ideal outcome is to give up only a few points and rely on the strength of their opinion given during direct examination.

QUALIFYING (OR DISQUALIFYING) VALUATION EXPERTS

Rule 702 of the Federal Rules of Evidence specifies guidelines that judges use for qualifying experts. The rule requires (a) experts provide testimony based upon sufficient facts and data in a particular case, (b) the opinion is the result of reliable principles and methods in a particular specialty or field, and (c) the expert has applied these principles and methods reliably to the facts of the particular case. In context, these judicial guidelines permit expert testimony at trial only if it is based on methodologies and principles accepted in the valuation field, those methods or principles are appropriate for the particular issue, and they are properly applied to the facts of the case. Although valuation principles and methods are well established and documented, model inputs and application vary depending upon the facts and circumstances of a particular case. Such variation, which is common and generally appropriate, is subject to a lawyer's challenge in an adversarial system.

Rule 104 (a) of the Federal Rules of Evidence requires the court to decide whether a witness is qualified to testify as an expert. As to experts in valuation, courts have discretion in deciding whether a potential expert witness is indeed qualified. A certification in valuation is one signal that someone has already undergone scrutiny by an outside organization. In the current environment, certification is generally important for practical reasons but a valuation certification is not absolutely necessary as courts find other ways to assess whether someone is indeed an expert.

Various organizations who grant valuation certifications have different criteria. Although it's possible to compare the criteria across organizations, differences are often perceived by others as not are often very important. Put simply, it's difficult for jurors to make important distinctions between experts simply because they have different valuation certifications.

In addition to certification, work experience in valuation might also be used to assess whether someone is qualified and credible. There are two aspects of experience qualifications at trial. First, a judge decides whether someone is qualified to testify as an expert. Second, after being declared an expert, a witness gives their opinions to the trier fact. A person's qualifications are only one of many factors that triers of fact might consider in deciding how much weight to give to a particular opinion. There are no generali-

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ties how courts perceive valuation experience. On one hand, someone who works mostly full-time in valuation might be perceived as being more qualified compared to someone who works less at valuations. Alternatively, an expert who works part-time in valuation and also works in related fields such as accounting might be perceived to be equally or, perhaps, more qualified to testify about a particular matter. For instance, someone who has expertise in accounting and valuation might be perceived as more qualified to evaluate the reliability of historical financial records used for valuation. Such assessment goes to minimizing the garbage in, garbage out phenomenon in valuation models.

Many factors affect perceptions of expert credibility and believability. It's not possible to generalize too much about such factors. First, industry experience might give an expert knowledge not otherwise known. It might be perceived as being important. For trial lawyers, such jury perceptions matter. However, industry experience alone doesn't make the opinion more correct compared to another person's opinion. Second, prior testifying experience can cut in both directions. On one hand, testifying a lot means an individual has been recognized as an expert numerous times. In contrast, testifying a lot might be perceived as being a hired gun. Perceptions are psychological and a result of many factors. For instance, someone who communicates well and comes across as being competent and unbiased can outweigh any perception of being a hired gun.

More experience in valuation, a particular industry, or a particular kind of dispute may have an impact on perceived expertise and credibility. But not every case demands someone with highly-specialized experience. Indeed, many cases cannot afford these kinds of experts. In contrast, the more money at stake often means the parties and attorneys are more willing to pay for more experienced and more specialized experts. It seems that courts adjust the bar for qualifying experts depending on the type and size of case while the evidentiary rules guiding the courts stay the same.

EXPERT CREDIBILITY BEFORE A TRIER OF FACT

Many of the issues described above in qualifying an expert also apply to the believability of an expert at trial. These include skills, knowledge, education, experience, and training. While the courts have judicial guidelines for qualifying experts, triers of fact have discretion in assessing expert testimony.

Take, for instance, an expert with significant industry and testifying experience. Although this kind of expert does not necessarily provide a more accurate opinion, jurors may decide their opinion should be given greater weight. Of course, these are generalizations and exceptions are possible. In some kinds of cases, someone who testifies a lot on valuations may be perceived as a hired gun and jurors may ultimately give more credibility to someone who testifies less frequently. Individuals with experience in merger and acquisition transactions have directly observed prices and motives of buyers and sellers. Sometimes this kind of experience is valuable. Other times it is not. In the 1996 Tax Court case of Pabst Brewing Company v. Commissioner, the court ruled that a dealmaker with 30 years of practical experience should be excluded because he was not a disinterested scientific evaluator.

Experts who have had their testimony previously excluded by a court of law might have problems later because of perceived credibility damage. But the degree of difficulty is relative to why the testimony was excluded in the first place. If an expert has been excluded because a court did not find an opinion believable, this is more serious than exclusion from a finding that predicate evidence was inadmissible for legal reasons. Simply put, prior exclusion of an expert can pose a problem for credibility but it is not necessarily damaging since it depends on the reasons why it occurred.

Opposing counsel might try to win points with a jury by trying to portray an expert as a hired gun. This could be attempted through clever questions that create an image. An expert can counter these kinds of questions by anticipating them and offering a response that is truthful but defuses inferences from such questions. For instance, an opposing attorney might ask an expert 'how much are you being paid for your testimony today?' This kind of question might cause the jury to perceive a witness as someone for hire. One possible defusing response might be ' I'm not being paid for my testimony. I'm being paid for my time like all my clients.'

Wise experts think about their marketing materials and activities. Virtually all professionals must market themselves because business is competitive. Those that provide expert testimony should be mindful what they say in marketing materials might later be put in front of jurors. Good advice is to write marketing materials so they are not misperceived by triers of fact or used as a weapon by opposing counsel.

Questions from opposing counsel about authoritative literature ought to be considered carefully. Such questions are a probable signal they have something specific in mind. A question such as 'Ms. Expert, do you recognize Shannon Pratt's book, Valuing a Business as authoritative' may mean that opposing counsel has found something in the text that they intend to use against the expert at trial. If this question is answered as a simple 'yes' at deposition, it's possible that some part of this book is going be read to the jury at trial in an attempt to discredit the expert by showing some conflict between the expert and publication. If the expert states a particular text is authoritative, it will be challenging to later say with credibility that they have a legitimate disagreement with it. Although valuation practitioners understand that valuation practice is driven by valuation theory and convention, untrained people such as jurors often don't appreciate the degree of judgment that professionals use. Consequently, if opposing counsel shows that an expert deviated from a book that they stipulated as authoritative, it may be a setback for the expert. Since valuation practice and theory do not arise from promulgated standards or regulation from an authoritative body, but instead of comes from interpretations of investor behavior and market forces, it's simply not possible that a particular valuation text is the final word on anything. Such texts are mainly educational but never authoritative because they are not written by any official body that promulgates rules and regulations. Indeed, a search on the term 'business valuation' on the Amazon website produces over 5000 results. Moreover, many texts have been written on valuation and there is no single source of authoritative literature on the subject. Simply put, business valuation texts are reference books for practitioners and not arbiters of how things must be done in practice. That is left partly to professional judgment, like medicine, accounting, law, and other professions. The task for valuation practitioners is to properly apply the facts and circumstances of the particular case to the appropriate valuation principles and methodologies. In many occasions, it's a matter of professional opinion rather than an outright rule.

Valuation experts, especially CPAs who have well-documented professional standards, are wise to be familiar with standards of

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Announcements:

Don and Betsy Wisehart of the Financial Valuation Group of New England, LLC and staunch Rotarians were among those who worked over 60 combined hours to make the 34th Annual South County Hot Air Balloon Festival an absolute success this past July 19-22, 2012 weekend. Don, the Wakefield's President Elect, said this amazing and fun RI tradition is an ongoing gathering of community, music, and of course lots of balloons. The event is held at the University of Rhode Island Athletic Fields in Kingston, Rhode Island each July, and features up to 14 hot air balloonists or aeronauts for three days of flying around Southern Rhode Island.

The Festival is the main fundraiser for the Rotary Club of Wakefield. Don and Betsy we are proud to say that since the festival's beginning, the Rotary Club of Wakefield has raised over $1,000,000. Holding true to the Rotary motto "Service Above Self", 100% of the proceeds from this event are donated and used for charitable purposes.

- Mike Crain will be teaching corporate finance to global MBA students for the Manchester Business School, University of Manchester (UK).

- Mike Crain will be speaking in November at the American Institute of CPAs annual Forensic and Valuation Services Conference on a panel with an attorney and other CPA-practitioner on malpractice issues in performing forensic and valuation services.

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The LIBOR Scandal: Can the FASB's New Proposals Help?

Michael J. Mard, CPA/ABV/CFF, ASA[1]

This article is about the Financial Accounting Standards Board's (FASB) ongoing effort to improve disclosure and transparency in fair value reporting, especially as it relates to financial instruments and more, specifically, to interest rates. Recent events revealing abuses in the LIBOR (London interbank offered rate) interest rate make the FASB's deliberations even timelier. The July 13, 2012 New York Times reported:

> *In April 2008, the Barclays employee mentioned to a New York Fed official, "where I would be able to borrow" in the Libor market, "without question it would be higher than the rate that I'm actually putting in." That same day, New York Fed officials wrote in a weekly internal memo that banks appeared to be understating the interest rates they would pay. "Our contacts at Libor contributing banks have indicated a tendency to underreport actual borrowing costs," New York Fed officials wrote, "to limit the potential for speculation about the institutions' liquidity problems."*

The Times article further points out that a multiyear inquiry by the regulators has included examinations of more than ten big banks that may be involved in this collusion. By understating the cost (LIBOR rate), value of assets such as derivatives including options may be overstated. Representative Randy Neugebauer, the chairman of the House Financial Services Subcommittee on Oversight and Investigations, was quoted in the same Times article as saying, "As much as $800 trillion in financial products are pegged to Libor, so any manipulation of this rate is of serious concern."

An e-newsletter from elawmarketing.com on July 25, 2012 states:

> *On June 27 … regulators … announced that they had reached a settlement with Barclay's, the giant British bank, in a case involving the fraudulent fixing of the so-called LIBOR interest rate. LIBOR …is the benchmark for trillions of dollars of loans worldwide – mortgage loans, small-business loans, personal loans, and interest rate derivatives contracts called swaps. The regulators allege that Barclay's made false daily submissions to the British Bankers' Association – which calculates LIBOR – probably from 2005 to 2009. The submissions are not based on an actual market rate of interest for interbank loans. Rather, submitters estimate what they think they would have to pay. Obviously, since all the big banks submit data, Barclay's normally could not manipulate LIBOR by itself; they would all have had to cooperate. And now, in its settlement agreement, Barclay's has admitted that this is exactly what happened, with the result that LIBOR deliberately underestimated the interest rates that the banks were paying for loans….*
>
> *…Charles Schwab, the brokerage firm and investment manager, has sued 11 major banks, claiming they conspired to manipulate LIBOR. Schwab contends that these banks altered the interest rates for LIBOR-based securities and deprived investors of the returns they would have earned had the numbers been accurate. The firm also alleges that by falsely depressing their borrowing costs, the banks "provided a false or misleading impression of their financial strength to investors" during the financial crisis of 2008.*

Can the Financial Accounting Standards Board's efforts help stem these admitted abuses? Yes, by requiring improved transparency in financial statements through increased disclosure, which will greatly aid investors and analysts in understanding the impacts of one of the most important costs to businesses and their values, interest rates.

The FASB proposes "…an interest rate sensitivity table (of) the effects on net income and shareholders' equity of specified hypothetical, instantaneous shifts of interest rate curves …." Further, the FASB would ensure adequate disclosures of the impact to liquidity on financial institutions that trade instruments sensitive to interest rates. These proposed liquidity risk disclosures "would provide information about the risks and uncertainties that a reporting entity might encounter in meeting its financial obligations. … (including a) tabular disclosure of the carrying amounts of classes of financial assets and financial liabilities … (and) a table (of) its available liquid funds …"

Issued as an Exposure Draft[2] on June 27, 2012, the FASB is inviting comments related to its proposal to increase disclosures about liquidity risk and interest rate risk pertaining to financial instruments. For more information on this exposure draft or to provide your own comments, visit www.fasb.org and click the "Exposure Documents" tab.~~

Footnotes:

[1] Mike Mard has worked with the FASB and served its Valuation Resource Group from 1998 - 2011.

[2] Proposed Accounting Standards Update on Financial Instruments (Topic 825).

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practice that affect them and be conversant about standards that don't affect them but might be used by opposing counsel. For instance, an attorney might ask a CPA-valuation expert 'did you follow generally accepted accounting principles?' A no answer might be misinterpreted by a jury as inappropriate behavior. With such a simple answer, even if appropriate, a jury may remain uninformed that generally accepted accounting principles don't apply to performance of valuation services. A better answer might be 'no, accounting principles don't apply to valuation projects. They apply to preparing financial statements.' Furthermore, opposing counsel might ask an expert which professional standards apply to this kind of work. An accurate response requires knowledge of the relevant professional literature. For CPAs, valuation services are subject to AICPA's Statement on Standards for Valuation Services, Code of Professional Conduct, and Statement on Standards for Consulting Services. If a CPA-expert doesn't know that these particular standards apply, their credibility can be damaged. Moreover, professional guidelines on valuation services can be confusing because there's so many organizations issuing their own guidelines. Although these guidelines are not substantively different in describing what ought to be done in performing a valuation analysis, some guideline terminology differs and each organization writes their literature in different degrees of detail. Moreover, suggested reporting disclosures differ somewhat across organizations because of organizational tradition and preferences. But such reporting guidelines don't affect opinions of value. They go to what is said in a report. Nevertheless, opposing counsel might attack the overall credibility of an expert by alleging some technical violation of published guidelines by saying the expert didn't say something in the report.

Drafts of reports prepared prior to a final version can be fodder for opposing counsel. Although Federal Rule of Civil Procedure 26 now specifies that draft reports no longer need to be disclosed, states often do not have a similar provision. Consequently, opposing counsel in state jurisdictions likely can still inquire about an expert's draft reports, request they produce them, ask why they weren't preserved, what changed between different versions, and so on. The related federal rule was amended recently to essentially make these and similar inquiries off limits because they are often meaningless to the litigation, a waste of time and money, and often don't get anyone closer to the truth. The philosophy of these federal guidelines is that developing an expert opinion is evolutionary based on a process of collecting voluminous and complex information, necessary conversation with a client's lawyer, careful thinking over time, weighing the facts, continually receiving new data, and so forth. Moreover, even though the federal rules were amended recently to eliminate disclosures of report drafts, The Appraisal Foundation (TAF) that promulgates the Uniform Standards of Professional Appraisal Practice (USPAP) may be headed in the opposite direction from this federal rule. Recent exposure drafts on possible changes to USPAP suggest TAF may be requiring appraisers to retain report drafts and document changes between versions.

Over the careers of accountants working with complex financial data, it's a virtual certainty they have made math errors that went undetected. Such errors may be important or inconsequential. If an expert makes a math error and opposing counsel points it out at trial, it's best that an expert acknowledge the error to preserve the perception of objectivity and integrity. But an expert may need to think fast to assess whether a math error has a significant effect on their opinion. He might acknowledge the error and then describe how it affects their overall opinion. If the math error is large or its effect unknown, an expert might ask for a break to calculate the effect. If an error is small, opposing counsel might not want the jury to know that but may want them to know that this accountant cannot add up the numbers, which has an effect on overall credibility.

Sometimes an expert may not have been provided with important information. They may not learn about it until facing cross-examination at trial. Opposing counsel might ask 'will these new facts change your opinion.' If the answer is yes, the expert should be honest in answering. But, like math errors, an expert may need to think fast by quickly assessing the magnitude of how their opinion might change. A simple yes with a small change in opinion is much different than a large change. Opposing counsel may not give an expert the opportunity to tell the jury how big a change would be. This may be an intentional tactic. But an expert might try is to answer the original question as yes and then add an explanation about its importance.

Financial experts sometimes rely on other experts in forming their opinion. For instance, a business valuation expert might rely on a real estate appraiser's opinion about the value of property. What happens when each side has its own real estate appraiser? On what basis does an expert rely on one real estate appraiser but not the other? Normally, an expert does not have the knowledge to evaluate the work of another kind of expert. One way to approach the situation is to simply state they are relying on a particular appraiser and their opinion. But the expert might anticipate being asked why they relied on that appraiser and not the other. Alternatively, an expert might consider both real estate opinions and perform calculations using each one. Moreover, opposing counsel might ask a financial expert whether they have the expertise to say which real estate appraisal is more accurate. The likely answer is no because there would be no reason otherwise to hire the other expert in first place.

Valuations of financial assets and other kinds of property are measured as of a particular date since values change over time. Specific valuation dates have important implications. First, who determines the measurement date? This is usually based on the facts and circumstances of a particular case. It may be best to have a client's attorney specify the date rather than having an expert interpret the case facts and essentially opine on a proper valuation date. The second issue on valuation dates goes to the principle that value is a function of information that is known or knowable as of a particular date. Since trials typically occur months or years after an event occurred, this principle may have large importance. If the assigned task is to determine the value as of a particular date, say, 12 months before trial, and important events occurred after this date, the court may need to decide whether the value on that date is appropriate for the particular legal issue. The theory of compensatory damages is to make an injured party whole. That may take the perspective of making them whole as of the trial date rather than the much earlier valuation date, a year earlier in this example. Consequently, if a court takes this perspective, a valuation opinion hasn't considered all the information the court has. In this case, it's not the fault of the expert. It's simply part of the litigation process whereby a court can take a different view from an attorney who specified the valuation date.

A financial expert valuing a business does so with a certain 'premise of value,' which is a valuation term of art. In most cases, the premise is the firm will operate as a going concern. Opposing

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counsel might ask an expert 'you stated in your report that you've assumed the business is a going concern. Doesn't this mean that the business will operate into perpetuity?' Data shows that family businesses often don't operate beyond the second or third generation. Thus, it's true that such businesses don't literally operate in the perpetuity, which is more than several millennia. Nevertheless, present value calculations and price multiples implicitly assign minimal value to earnings in the distant future. Thus, the perpetuity assumption, although not literally true, is practically true and is commonly done in finance and valuation theory and practice to simplify the mathematics and language. A different way to view this going-concern issue is that expected benefits from owning an investment received in the near future are much more important to investors than benefits in the distant future. This is intuitive and affects human behavior. Consequently, the perpetuity assumption and possible lifespans of family and other small businesses ending in the distant future are relatively unimportant because their effect on current value is small.

CONCLUSION

Valuation is different than financial accounting. Valuation has a forward-looking perspective because of investor behavior. Investors think about their future return on investment. In contrast, financial accounting has a historical perspective. Consequently, it's grounded in collecting empirical data on historical transactions. Valuation, on the other hand, requires significant professional judgment to assess expectations because such expectations are unobservable. Consequently, testimony of valuation experts has different characteristics than accounting testimony that opens the door to more challenges in an adversarial system.~~