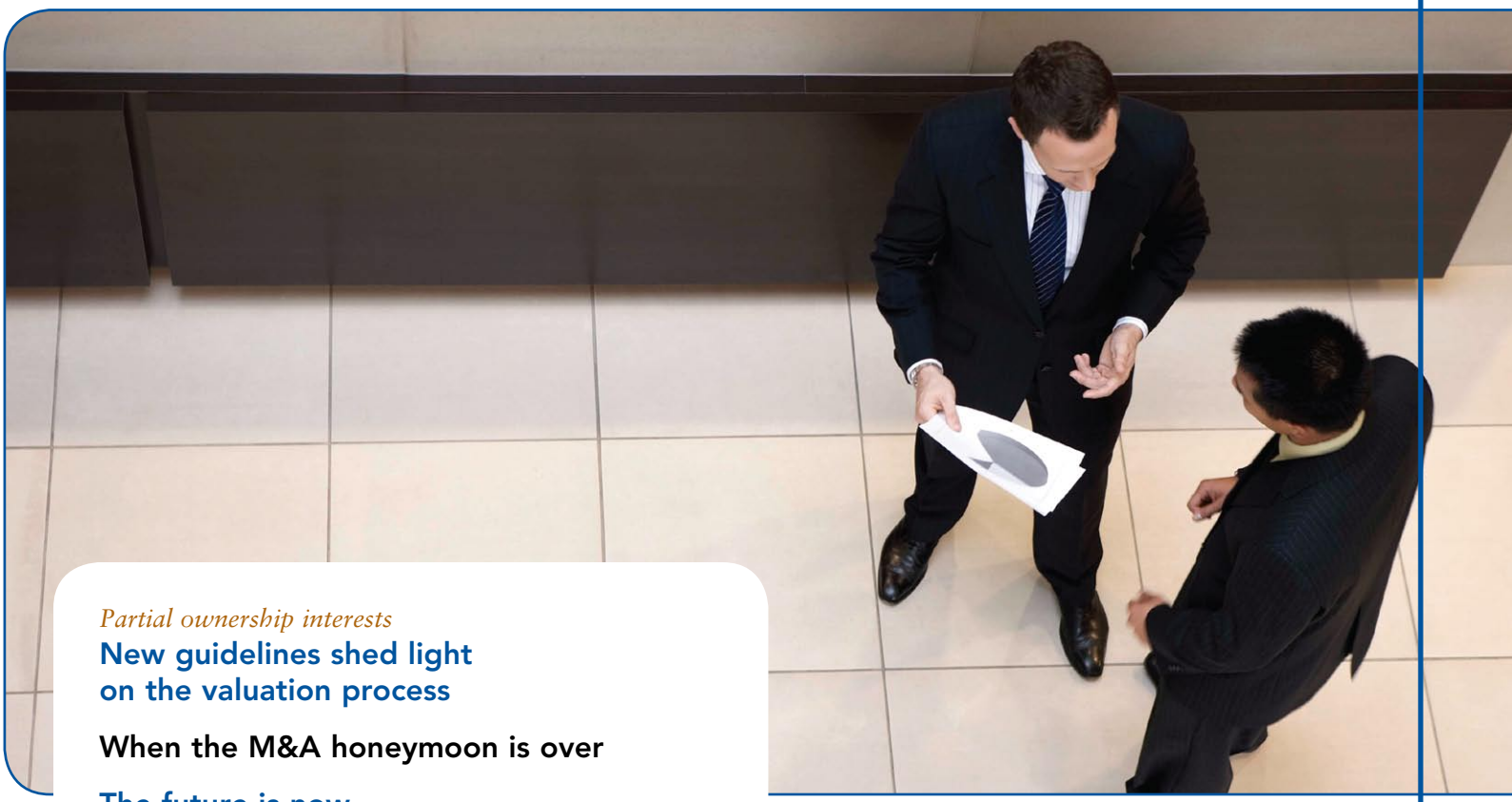
Advocate's EDGE



Partial ownership interests

New guidelines shed light on the valuation process

When the M&A honeymoon is over

The future is now

Court debuts electronic discovery program

Time to tighten internal controls

July/August 2010

McGOVERN & GREENE LLP

CPAs & Forensic Accountants

Partial ownership interests

New guidelines shed light on the valuation process

Business valuators are often retained to value partial ownership interests. In recognition of this common type of engagement, the American Society of Appraisers (ASA) last year adopted procedural guidelines to describe the considerations and procedures that may be used to value partial interests in businesses, securities, and other tangible or intangible property. Although the guidelines aren't binding, they provide valuable information on what you and your clients can expect from such a valuation.

OWNERSHIP AND CONTROL ARE DIFFERENT

The ASA guidelines define partial ownership interests as interests in an enterprise or asset of less than 100%. Partial interests can exist in various types of business entities and certain tangible and intangible assets. They may range in position from near control to little control of an entity.

The process of valuing a partial interest can vary greatly from the process of valuing the underlying entity or asset.

The degree of *ownership* in an entity doesn't necessarily reflect the degree of *control* over that entity. Governance documents, loan covenants and other factors can convey control to interests of less than 50%. For example, a 65% limited partnership interest could have no control over the partnership if the partnership agreement requires a two-thirds majority vote of the limited partnership interests to remove the general partner. Conversely, a 2% interest could wield some limited control over an entity if the two other owners each have 49% interests and hold contrary views.

DETERMINING RELEVANT FACTORS

As the ASA guidelines note, the process of valuing a partial interest can vary greatly from the process of valuing the underlying entity or asset. Further, the value of the underlying entity or asset might not even prove relevant to the value of the partial interest — particularly if the partial interest doesn't enable its owner to liquidate an entity, cause its sale or gain access to any of the assets. Of course, the value of the underlying entity or asset is likely to be relevant if investors or market participants would consider its value in determining the value of a partial interest in it.

The guidelines list several factors that valuators may consider when valuing such interests. This includes the purpose of the valuation, the value of the underlying entity or asset (if applicable), and any entity- or asset-level tax effects.

ANALYZING THE HOLDING PERIOD

The American Society of Appraisers' guidelines for valuing partial ownership interests identify the expected holding period for an investment as a potentially relevant valuation factor. The guidelines indicate that analysis of the period should consider:

- Any uncertainty about the expected holding period,
- Expiration or termination dates specified in governing documents that may prompt a liquidation or sale of the underlying entity,
- The age, health and other characteristics of the owners and key managers,
- Past transactions involving partial interests in the underlying entity or asset,
- The potential market for similar entities or assets, and
- The attractiveness of the entity for an equity offering, sale or merger.

Relevant factors specific to the partial interest itself include:

- Provisions in the organizational and governance documents that affect the rights, restrictions, marketability and liquidity of the partial interest,
- Applicable laws and regulations, such as statutory rights to demand dissolution or restrictions on transferability,
- The existing ownership structure and configuration,
- Access to, availability of and reliability of data regarding the underlying entity or asset,
- Any relevant pool of potential buyers,
- Market data on transactions in similar markets,
- The expected holding period for an investment in the partial interest (see "Analyzing the holding period" above),
- The required return for investing in the partial interest, and
- Any relevant ownership-level tax effects.

The valuator may also consider expected economic benefits associated with the partial interest in the form of interim dividends or distributions to the interest, as well as the net cash flow that will result when the investment is sold or liquidated.

GUIDELINES IN PRACTICE

Keep in mind that these are only suggested procedures and that your expert may determine that circumstances call for a different approach. Nevertheless, the guidelines suggest the type of information you and your client will need to supply. They also can help you develop a more informed and effective cross-examination of an opposing expert's conclusions.

When the M&A honeymoon is over

Merger and acquisition (M&A) transactions are notoriously difficult to execute. Even if a deal makes it as far as closing, it's likely to stumble at the integration stage. In some cases, sellers and buyers engage in postclosing disputes over previous financial representations and the company's selling price. If your client's in this situation, a financial expert with M&A experience can help.

RULES OF COURTSHIP

Most M&A agreements contain representations, warranties and covenants, as well as an indemnification provision in the event of a breach. The seller, for example, may represent that its financial statements were prepared in accordance with Generally Accepted Accounting Principles (GAAP) and warrant that no liabilities exist other than those already disclosed.

Covenants can do everything from requiring the parties to take specific actions to close the transaction to mandating that the seller maintain a set level of working capital. In many deals, the selling company's ability to live up to its earnings potential is uncertain. Therefore, the initial purchase price typically is based on the assumption that the company won't achieve its potential, with additional consideration to be paid if the company meets certain financial targets (generally referred to as an earnout agreement).

An earnout agreement may be designed to prevent the party in control of the business from manipulating revenues, income, or cash flow to increase or decrease earnout payments. Suppose, for example, that the seller's management team continues to operate the business after closing. Without a covenant, an income-based earnout provision could provide an incentive to cut expenses to boost earnout payments.

TROUBLE IN PARADISE

One of the most highly litigated contract provisions involves postclosing adjustments to the purchase price — not surprising, considering accounting decisions involve subjective, professional judgment. Common disputes involve alleged misrepresentations or breaches of covenants or warranties by the seller. Disagreements over postclosing purchase price adjustments and earnout payments also frequently flare up.

A buyer may claim, for example, that the seller misrepresented the company's financial condition by recognizing revenue prematurely or understating expenses or liabilities, thus inflating the buyer's valuation of the company. But proving detrimental reliance on the financial statements can be challenging, because the purchase price is influenced by many factors in addition to the target's financial condition and earnings trends.

Postclosing disputes also arise because the language in the sales agreement is ambiguous or vague. There's a common misconception, for instance, that GAAP dictates a precise number when, in fact, it permits the use of different methods and leaves ample room for subjective judgment. Here again, proof can be a challenge: It may be difficult to distinguish between selecting the most appropriate accounting method for a particular situation and choosing a method that produces a postclosing adjustment in the seller's favor.

Similar issues can arise in the context of earnout provisions. Are management's postclosing business and accounting practices commercially reasonable and consistent with applicable standards? Or are they designed to manipulate earnings benchmarks to increase or decrease earnout payments?

A THIRD PARTY STEPS IN

Most M&A agreements provide for disputes to be resolved through arbitration or some other form of alternative dispute resolution, and accountants are well suited to the arbitrator's role. They may serve as consulting or testifying experts by:

- Interpreting applicable accounting standards,
- Analyzing the target company's accounting practices,
- Identifying potential discrepancies in the closing-date financial statements, and
- Weighing in on challenges to postclosing adjustments.

If an agreement contains an earnout provision, this expert can help determine whether earnings targets have been met. And he or she can provide an opinion as to whether postclosing actions are commercially reasonable — or simply a pretext for manipulating earnout provisions. Accountants also can help attorneys draft discovery requests to uncover audit workpapers, consultants' reports and other documents that shed light on the target's accounting policies and practices.

HAPPILY EVER AFTER?

Even the best M&A agreement can't prevent every postclosing dispute. Whether your client is a business buyer or seller, a financial expert can help when the honeymoon's over.

The future is now

Court debuts electronic discovery program

In 2009, the Seventh Circuit Court of Appeals launched a program that points the way to some potentially significant changes in the discovery process. The goal of the court's Electronic Discovery Pilot Program is to reduce litigation costs and time brought on by the widespread use of electronically stored information (ESI).

ADDRESSING ESI EARLY

The Seventh Circuit's E-Discovery Committee has developed an initial set of guidelines, the "Principles Relating to the Discovery of Electronically Stored Information," to "incentivize early and informal information exchange on commonly encountered issues relating to evidence preservation and discovery, paper and electronic." These principles require that litigation participants address and resolve ESI issues early in the process — with an agreement between the parties or by raising them with the court.

Other organizations have provided similar guidance in the past but, unlike those, the Seventh Circuit's principles have been subjected to testing. In the program's initial stage, which occurred between

October 2009 and May 2010, individual district court, magistrate and bankruptcy judges in the circuit adopted the principles and implemented them in selected cases.

SPEED AND COOPERATION

According to the Seventh Circuit, the principles are intended to assist courts in administering Federal Rule of Civil Procedure (FRCP) 1, which requires the "just, speedy and inexpensive" determination of cases. The program also reinforces the need for cooperation in discovery and the importance of applying FRCP 26(b)(2)(C)'s proportionality standard when formulating a discovery plan.

Several proposals could streamline the discovery process. For example, the court suggests that the "meet and confer" process that precedes the initial status conference with the court can be improved by the participation of e-discovery liaisons. One of the principles requires that each party designate an individual to act as its e-discovery liaison. In the event of a dispute over preservation or production of ESI, the liaisons can meet, confer and attend court hearings on the subject.

Attorneys, third-party consultants or employees of the party all are qualified to be liaisons. They also must be:

1. Prepared to participate in e-discovery dispute resolution,

2. Knowledgeable about the party's e-discovery efforts,

3. Familiar enough with the party's electronic systems and capabilities to explain those systems and answer relevant questions (or have reasonable access to those who are), and

4. Knowledgeable about the technical aspects of e-discovery (or have access to those who are).

The principles also explicitly identify ESI categories that "generally are not discoverable," such as:

- Deleted, slack, fragmented or unallocated data on hard drives,
- Random access memory (RAM) or other ephemeral data,
- Online access data like temporary Internet files, history, cache and cookies,
- Data in metadata fields that typically are updated automatically,
- Backup data that's substantially duplicative of data that's more accessible elsewhere, and
- Other forms of ESI whose preservation requires extraordinary affirmative measures that aren't used in the ordinary course of business.

Under the principles, any party that intends to request the preservation or production of these categories should discuss its intention at the "meet and confer" or as soon thereafter as practicable. If the parties can't come to agreement, the issue should be raised promptly with the court.

SIGN OF THINGS TO COME

The Seventh Circuit's principles address several other critical issues, including the identification of ESI, preservation requests, and production format for non-text-searchable information and ESI stored in databases. Its committee is expected to formally present its findings on all of these issues and release final principles in May 2011.

Time to tighten internal controls

The recent economic downturn has provided ideal conditions for occupational fraud — cash-strapped employees combined with less-stringent fraud prevention measures. Strong, well-targeted internal controls can make it harder for thieves but, unfortunately, many companies' controls are inadequate. Now more than ever, your clients need a forensic expert to perform a fraud risk assessment.

PERFECT STORM

A 2009 study of the weak economy's impact on occupational fraud highlights your clients' potential vulnerabilities. The Association of Certified Fraud Examiners (ACFE) surveyed more than 500 certified fraud examiners (CFEs) about fraud in a recessionary environment.

Of the respondents who worked as in-house fraud examiners, 59% reported that their organizations had experienced layoffs or similar staffing reductions in the previous year.

Because reductions typically result in lower morale, increased workloads and greater performance pressure for remaining staff, employees may be more motivated to commit fraud. The survey also found that more than one-third of the organizations that conducted layoffs also eliminated some internal controls, providing greater opportunity for potential fraud perpetrators.

ASSESSING THE RISKS

Businesses with specific risks such as an overextended workforce should ask a fraud expert to review their current internal controls to determine whether they're adequate. Forensic experts typically start their risk assessment with the following five ACFE-recommended steps:

1. Determine the threats that confront the organization,
2. Estimate the probability of each threat actually occurring,
3. Estimate the potential loss from each threat,
4. Identify controls to guard against the threats, and
5. Weigh the costs and benefits of implementing the controls.

If the benefits outweigh the costs, the organization generally is advised to consider additional controls. Many companies are on tight budgets these days and may be tempted to avoid any new expenditure. However, skimping on controls now can result in much bigger financial losses later.

KEY CHANGES

Many internal control upgrades can be simple and inexpensive. One of the most effective fraud-prevention measures is segregating duties — or assigning different employees to approve, record and report financial transactions. If possible, these tasks should occasionally rotate among employees and all accounting department staff should be required to take periodic vacations.

Anonymous fraud hotlines — which are required of public companies, but recommended for private businesses as well — also help rout out fraud. The ACFE has consistently found that tips from employees, vendors and customers are the most common means of detecting occupational fraud. Other effective internal controls include fraud awareness training, independent audits, restricting employees' access to only information necessary to perform their jobs and regular reconciliation of financial documents.

But even organizations with these controls in place can fall victim if they allow management to regularly override controls. Management overrides should be allowed only in extreme circumstances and according to specific procedures.

ONGOING VIGILANCE

Risk assessment and adjustment of internal controls isn't a one-time exercise. Organizations' circumstances and risks change over time, so your clients should review their controls periodically — or whenever a fraud incident arises.