

# — Advocate'sEDGE —



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*Which one does your client need?*

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value of a financial expert**

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# Full valuation vs. calculation of value

*Which one does your client need?*

Attorneys call on appraisal experts to provide various services, including both full valuations and calculations of value. While the two may sound the same, full valuations are preferable in certain circumstances.

## FULL VALUATIONS

Business valuation analysts must follow the professional standards of the appraisal organizations with which they are affiliated. For example, CPAs with the Accredited in Business Valuation (ABV) designation must follow the standards set forth by the American Institute of Certified Public Accountants (AICPA). Each appraisal organization has its own set of professional standards. Although these standards



vary from each other somewhat, they generally concur on the amount of research and analysis required to prepare a full valuation.

According to the AICPA’s Statement on Standards for Valuation Services No. 1 (SSVS 1), for example, a full valuation is performed when the valuation analyst:

- ▶ Is asked to estimate the value of the subject interest,
- ▶ Estimates the value in accordance with SSVS 1,
- ▶ Is free to apply the valuation approaches and methods he or she deems appropriate for the circumstances, and
- ▶ Expresses the results of the valuation as a “conclusion of value.”

This type of engagement is often most appropriate for litigation — including divorce proceedings — and estate and gift tax filings.

## CALCULATIONS OF VALUE

Under SSVS 1, a calculation of value is performed when three conditions are met:

1. The valuation analyst and client agree on the valuation approaches and methods the analyst will use and the extent of procedures he or she will perform in the process of calculating the value of the subject interest. These procedures typically will be more limited than those in a full valuation engagement.
2. The analyst calculates the value in accordance with the agreement.
3. The analyst expresses the result as a calculated value.

## COURT REJECTS CALCULATION OF VALUE

A recent shareholder dispute provides a good example of courts' preferences for full valuations over calculations of value (see main article). *Surgem, LLC v. Seitz*, heard by the New Jersey appellate court, involved a minority shareholder's interest in a company that provided management services to ambulatory surgical centers.



The expert for the minority shareholder testified that he'd been engaged to prepare only a calculation of value using the method determined by the client. He further testified that his client didn't supply him with numerous materials that were necessary for a full valuation. In addition, the expert acknowledged that more work should have been done for him to arrive at a formal conclusion of the business's fair market value.

After rejecting the calculation of value set forth by the minority shareholder's expert, the trial court found the opposing expert's full valuation report uncontroverted. The lower court therefore accepted his analysis and calculations, and the appellate court affirmed.

SSVS 1 explicitly indicates that the valuation analyst should qualify the calculated value by stating in the report that the calculation doesn't include all of the procedures required for a full valuation. The analyst might also add a disclaimer that, if a full valuation had been performed, the results could have been different.

Sometimes, though, a full valuation isn't necessary or possible, and a calculation of value will suffice — for example, when the analyst doesn't have complete access to all of the relevant information. A calculation of value also could be appropriate for negotiating the purchase or sale of a business, for facilitating settlements or for mediation purposes. Your clients may further find a calculation of value useful for strategic planning, including tax and estate planning, and key-person insurance purposes.

### COMPREHENSIVE OFTEN IS PREFERRED

As previously discussed, a calculation engagement is limited in scope and won't consider any valuation approaches and methods beyond those agreed upon with the client. In fact, many experts consider a calculation of value a “quick

and dirty” estimate of a subject interest's value. Unlike a full valuation, a calculation of value typically doesn't involve a detailed report that can be time-consuming to produce. Instead, a calculation engagement might lead to an abbreviated letter report, numerical exhibits or oral presentations.

Although there's no rule against testifying based on a calculation of value, courts usually prefer the more comprehensive full valuation. (See “Court rejects calculation of value” above.) The IRS and Securities and Exchange Commission also typically prefer full valuations. For example, the IRS lays out guidelines for supporting documentation for tax purposes, which calculations of value don't satisfy.

### SELECTING THE RIGHT SERVICE

Calculations of value typically are less expensive than full valuations, and it may be tempting to cut corners on price. But the tab could end up much higher in the long run if the appraiser's limited procedures and reporting format prove inadequate for your client's needs. To ensure you retain the appropriate service, provide your valuation expert with as much information as possible at the beginning of the process. ▀

# Confirming worst suspicions

*Hire a forensic expert to find hidden assets*

When a client voiced strong suspicions that her soon-to-be ex-husband was hiding assets, her attorney investigated the claim but found nothing amiss. However, he hired a forensic accounting expert to help ensure his client would receive an equitable share of the marital estate. The expert turned up a trunkload of hidden treasure — undeclared cash income and property “stashed” under the names of the husband’s mother and siblings.

Deceptive spouses — and other parties to litigation — often are experts at hiding assets. To protect your client from such scam artists, you’ll need your own expert.

## GATHERING DATA

To begin their search for hidden assets, financial experts request information and records relating to the spouse’s employment and financial holdings. Details about all sources of income (including pending litigation and insurance settlements), and all banks, brokerage firms and other financial institutions where the spouse has held accounts, are critical.

*A deceptive spouse may use business funds to purchase personal assets, such as cars and real estate.*

Experts also need to know about the spouse’s lifestyle and personal spending habits, as well as his or her personal and business relationships. The individual could be funneling income or assets to family members, friends and business associates.

Tax returns can be a particularly rich source of information. Itemized deductions listed on Schedule A, for example, may suggest that the



spouse is living beyond his or her apparent means, in turn raising the possibility of hidden assets. It’s important to investigate whether the deductions for property taxes, mortgage interest and charitable giving are proportionate to reported income.

## METHODS THAT WORK

Experts use one or more of several methods to ferret out assets:

**Net worth.** The spouse’s net worth (assets less liabilities) at the beginning of a period is compared with the ending net worth. Information about assets might be accessed through bank and brokerage records, tax returns, and credit applications.

**Expenditure.** This strategy is deployed by matching the spouse’s total personal expenditures during a period of time — using evidence from bank statements and canceled checks — against the available sources of funds. These sources can include salary, loans, gifts, inheritances and cash on hand at the beginning of the period.

**Bank deposits.** This method assumes that money is either spent or deposited. Thus, net deposits (deposits less transfers and redeposits) are added to cash expenditures to calculate total receipts. Funds from known sources are then deducted to calculate the total funds from unknown sources.



## BUSINESS OWNERS POSE PARTICULAR CHALLENGES

If the suspected scammer is a business owner, he or she may try to use the company to mask assets and income. A deceptive spouse, for example, may use business funds to purchase personal assets, such as cars and real estate, or to cover personal expenses, such as mobile phone bills, insurance premiums or club membership dues. All of these expenditures can reduce the business's net income, thereby reducing its value as a marital asset.

The business also could have unreported income. A forensic accounting expert will scrutinize:

- ▶ Actual expenses,
- ▶ Associated expected sales,
- ▶ Accounts receivable,

- ▶ Journal entry write-offs,
- ▶ Internal controls (and the owner's ability to override them), and
- ▶ Expected profitability.

Finally, an expert will search for related-party transactions. These are important because they can indicate the owner's attempts to divert income from the business.

## WHAT CLIENTS DESERVE

No matter how well-intentioned, clients and attorneys are unlikely to be able to find all of a deceptive spouse's hidden assets or income on their own. Forensic accountants, on the other hand, are trained to gather relevant data, scour it for anomalies and prove that the opposing party is being dishonest. This is the kind of expertise your client deserves. ▶

# Keys to ESI authentication

Electronically stored information (ESI) has assumed a prominent role in commercial and other types of litigation. Like any evidence, it must satisfy the rules for authentication.

Unfortunately, ESI faces some unusual authentication hurdles. Unlike static paper financial statements and other documents, ESI is typically a collection of information produced by computer systems and can easily be edited without leaving any record of prior versions. Authentication, therefore, requires sufficient evidence to establish that the ESI hasn't been changed since its creation or a particular relevant date. Qualified experts must use several methods to ensure this type of evidence is admissible at trial.

## TECHNOLOGICAL AVENUES

The federal and state rules of evidence generally allow a proponent of evidence to authenticate it through its "appearance, contents, substance,



internal patterns, or other distinctive characteristics, taken in conjunction with circumstances.” These rules could cover several types of ESI authentication, including:

**Hashing.** Every electronic file is assigned a “hash value,” or unique numerical identifier. One judge has described hashing as “a digital equivalent of the Bates stamp used in paper document

production.” A new hash value is created each time a file is modified, so hashing can be used to guarantee the authenticity of an original data set and, in turn, establish that another file is an exact duplicate.

**Metadata.** System metadata is created by the operating systems that run computers, servers and other devices. All electronic files include metadata that conveys information, such as the dates a file was created, last modified and last accessed. Metadata, however, is vulnerable to undetectable manipulation and can be deleted with access to the file. Metadata also changes each time a file is opened, which can compromise the usefulness of the information for authentication.

**Digital signatures.** A digital signature requires the signer to have a certificate-based digital ID. Digital certificates, which are issued by a “trusted authority” or “certificate authority,” are the critical component in Public Key Infrastructure (PKI) and are used in the digital signature process in a way that can provide authentication.

But the presence of a digital signature indicates only that *someone* with access to the ID has signed the document. The proponent of the ESI must link it to the specific individual. What’s more, it’s impossible to establish when the digital signature was created. For these reasons, digital signatures are best used in conjunction with other authentication methods.

## SELF-AUTHENTICATING METHODS

The rules of evidence generally recognize several methods of self-authentication. Trusted time stamping may allow for the self-authentication of ESI if it can verifiably establish an accurate and nonalterable time for the evidence.

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According to the rules of evidence, another permissible method of self-authentication for ESI is by “inscriptions, signs, tags, or labels purporting to have been affixed in the course of business and indicating ownership, control, or origin.” For example, corporate e-mails frequently identify the origin of the transmission and the company.

## EXPERT WITNESS TESTIMONY

Experts with relevant knowledge can offer testimony that establishes the integrity of ESI by showing that it hasn’t been modified since its creation. Experts don’t need to have personal knowledge of a particular piece of ESI as long as they can testify to applicable safeguards and the process by which it was created and preserved.

Experts also can authenticate ESI on the stand. For example, an expert witness might compare it with other pieces of ESI that have already been authenticated.

## PLANNING AHEAD

Each type of ESI comes with specific challenges. Work with your expert to determine the relevant authentication requirements and to anticipate your opponent’s likely attacks on the evidence. ▀



*Apple, Inc. v. Samsung Electronics Co., Ltd.*

## Tech giant learns the value of a financial expert

Apple made headlines last spring when a jury awarded it \$120 million on patent infringement claims against Samsung. But that case was just one component of ongoing litigation between the two companies. In the first case last year, *Apple, Inc. v. Samsung Electronics Co., Ltd.*, Apple learned a hard lesson about the need for a financial expert when seeking lost profits damages.

### DIY DAMAGES

After a jury initially awarded Apple about \$1 billion, the Northern California district court ordered a retrial on damages. Apple's own damages experts concluded that it wasn't eligible for lost profits, but Apple declared — less than 24 hours before the retrial was to begin — that it intended to argue for those lost profits anyway. Samsung filed an emergency motion to preclude Apple from arguing for lost profits.

Apple didn't contest that lost profits weren't available under the damages model used by its experts. Instead, the company argued that it could prove its entitlement to lost profits without relying on its experts.

### THE COURT'S CONCERNS

However, Apple didn't disclose an alternative theory of lost profits in any of its relevant submissions or oral arguments. The court found that Apple's failure to disclose its new damages theory in a timely manner was reason enough to exclude the theory. Allowing the theory at that point risked severely prejudicing Samsung, confusing the issues, misleading the jury and wasting time.

The court had another concern: Apple didn't explain how it expected the jury to calculate lost profits without concrete guidance as to how to do so. Apple didn't propose to offer the jury an actual lost profits figure but indicated it intended the jury to generate "an appropriate amount of damages to compensate Apple for lost profits." The court found such a task particularly difficult in a case where the issues were complex, the parties were large companies and the damages evidence was hotly contested.



A jury, the court stated, "may not award lost profits in a patent case in the absence of 'sound economic proof.'" This rule applies regardless of the method the patentee uses to prove lost profits.

### SOLID FOUNDATION

The district court excluded Apple's new lost profits theory, noting that it wouldn't invite the jury to come up with an award founded on little more than pure speculation. Don't risk Apple's strategy. A financial expert can help you guide juries to lost profits awards with a solid foundation. ▀