BCC Advisers Litigation & Valuation Report

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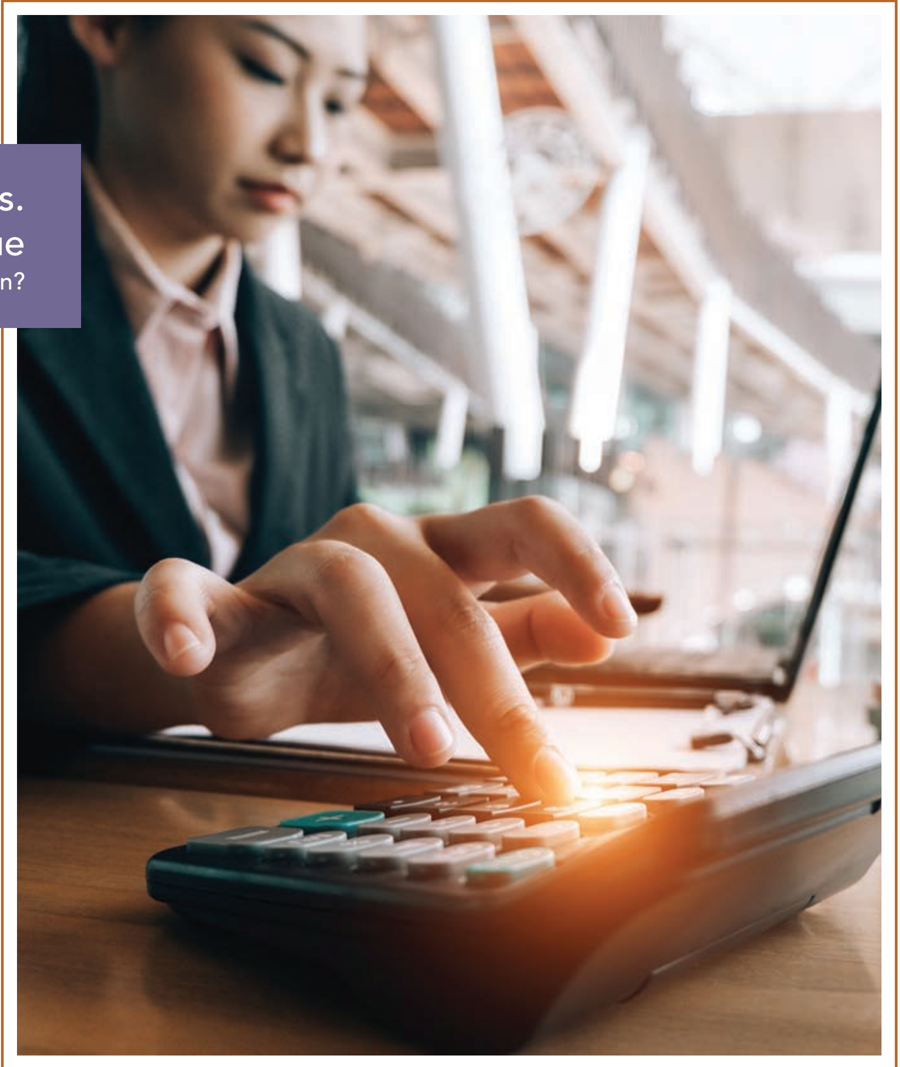

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Calculation vs. conclusion of value

Which level of service is appropriate in litigation?

Business valuation experts generally can be engaged to provide either a "conclusion of value" or a "calculation of value." While these terms sound similar, there are significant differences between these two types of engagements.

Overview of professional standards

Most professional standards that govern the work of business valuation professionals — including the AICPA's Statement on Standards for Valuation Services VS Section 100 (VS 100) — identify two types of professional service engagements:

1. Valuations. During a *valuation*, the analyst, in opining on the value of the subject interest, "is free to apply the valuation approaches and methods he or she deems appropriate in the circumstances," according to VS 100. He or she expresses the results of the valuation as a *conclusion* of value; it may be either a single amount or a range.

In a litigation setting, a calculation is rarely appropriate, because it doesn't result in an opinion of value.

2. Calculations. With a *calculation*, "the valuation analyst and the client agree on the valuation approaches and methods the valuation analyst will use and the extent of procedures the valuation analyst will perform in the process of calculating the value of a subject interest," according to VS 100. Like a conclusion of value, the results of a calculated value may be stated as either a single amount or a range.

The professional standards of other valuation organizations, such as the National Association of Certified

Valuation Analysts (NACVA) and the American Society of Appraisers (ASA), provide similar guidance.

Limits of calculations

The development and reporting requirements for a calculation are generally far less stringent than those that apply to valuations. For example, to keep costs down, the parties might agree that the valuation analyst will rely on the capitalization of earnings method and won't consider any market- or asset-based valuation approaches, which would require a significant amount of work. They might also agree to limit or eliminate certain valuation procedures, such as site visits or management interviews.

A calculated value can be a cost-effective tool under the right circumstances. For example, it might be appropriate in strategic planning, transaction planning or out-of-court settlement negotiations, particularly when the analyst lacks access to the financial information necessary for a full valuation engagement.

Calculation of value admissible in divorce case

In *Horne-Ballard v. Ballard*, a key issue was the value of the wife's medical practice. The trial court made no findings of fact regarding the practice's value. However, the $550,000 alimony-in-gross award to the husband implied that the court had relied on a *calculation* engagement performed by the husband's expert to estimate the practice's value.

The husband's expert arrived at a *calculation* of value of $2,470,000. The expert testified that she was able to eliminate certain calculations she felt were inappropriate and that "a calculation of value requires less speculation than does an opinion of value."

Conversely, the wife's expert conducted a comprehensive *valuation* and opined that the value of the practice was only $241,000. The expert's report detailed the additional factors and estimates used to reach that opinion.

At trial and again on appeal, the wife argued that a *conclusion* of value is "much more exacting" than a *calculation* of value, and, therefore, a calculation shouldn't be admissible at trial. The trial court found, and an Alabama appellate court agreed, that her objection went to the expert testimony's weight and credibility, not its admissibility.

The trial court stated that it would consider the wife's arguments in determining the weight to give the calculation of value. Therefore, the appellate court declined to substitute its judgment for that of the trial court when deciding whether the expert's calculation of value should be admitted into evidence.

However, in a litigation setting, a calculation is rarely appropriate, because it doesn't result in an opinion of value. Moreover, calculations may be susceptible to manipulation and inaccuracy. For example, the asset-based (or cost) approach to valuation often results in lower values than the income or market approaches. So, a party seeking a lower value might opt for a calculation of value based solely on the asset-based approach.

Similarly, in the COVID-19 environment, certain valuation approaches and methods may be more relevant than others. For example, market-based methods that utilize pre-pandemic transaction data may be less reliable than discounted cash flow or other income-based techniques. A calculation engagement that's limited to only the market approach would prevent the analyst from using his or her professional judgment to select the most appropriate valuation methods.

That's not to say that calculations of value are prohibited in litigation. Courts have ruled that calculation reports are admissible. (See "Calculation of value admissible in divorce case" above.) But, given their limited scope, calculations are unlikely to be viewed as credible or persuasive.

A calculated risk

Even if calculations of value are admissible, relying on them in litigation is risky because calculated values are inherently less reliable than value conclusions. A calculation report will generally contain cautionary language, indicating that 1) the analyst didn't perform all the necessary procedures required for a valuation engagement, and 2) the results may have differed if a valuation engagement had been performed. Beware: These admissions may raise a red flag to opposing counsel and discredit the expert's conclusion in the eyes of the court. ■

Restructuring: How business owners can get their groove back

The COVID-19 crisis has affected virtually every business. Many small business owners may be ready to throw in the towel, but restructuring can provide a fresh start. This is a highly complex process that needs to be continuously monitored for possible revisions, especially in today's uncertain, volatile market conditions.

Here are four ways financial experts can help management get back in the groove by harnessing cash flow and actively managing the company's finances.

1. Create three- to six-month cash flow projections

Budgets and forecasts that owners made in January were typically replaced by gut instinct and short-term working capital management strategies during the first several months of the pandemic. Getting back on track starts by formally projecting cash flow for the next three to six months.

These projections can help identify current sources and uses of cash — along with possible shortcomings. Then owners can brainstorm ways to bridge gaps (such as lines of credit or small business loans) and eliminate major drains on cash (such as unprofitable business segments or excessive overhead expenses).

One key area to focus on during recovery is *collections*. It's critical to send bills out on time and follow up with customers once their payment deadlines have passed. Nobody likes making collection calls. But, if a customer has a serious problem, it's better to find out as soon as possible and negotiate the best possible outcome.

2. Get debt under control

Businesses with heavy debt loads may need help renegotiating their loan terms to facilitate an effective restructuring. For example, an owner might request a lower interest rate, a longer amortization period or possibly even debt forgiveness. However, beware: Cancellation of debt may have tax consequences.

Another strategy is a debt-for-equity exchange, which is when a creditor replaces its debt with a percentage of ownership in the business. This solution could result in a surrender of company leadership, depending on how much control creditors gain. But the flipside is the prospect of future growth: Debt-for-equity frees up money that the company would have previously spent on debt repayment.

Coming to a debt agreement with creditors isn't always possible. But it's worth a try for businesses with strong working relationships with these parties, because it helps preserve the company's credit rating and reputation.

3. Monitor business essentials

Another proactive step toward recovery is closely managing operational functions. For instance, does the company's accounting system provide the information needed to make effective day-to-day business decisions? The system should generate weekly performance summaries that provide management

with relevant, real-time information, allowing them to pivot based on changes in the marketplace. In addition, several major changes to the accounting rules in recent years may necessitate an accounting system upgrade.

Business owners also should meet with their financial advisors before year end to brainstorm ways to lower their tax obligations for 2020. Plus, there may be opportunities under COVID-19-related financial relief measures to file amended returns for *prior* tax years. Amended returns may provide tax refunds that can be used to cover current expenses.

4. Invest in marketing

A big mistake some struggling businesses make during economic downturns is to reduce spending on advertising and other marketing-related efforts. But if owners cut marketing expenses too heavily, they'll end up without the new business needed to survive — and revenue will flatline.

Marketing personnel can also help management develop new products and services or find market segments that haven't been tapped into yet. However, owners should avoid straying too far from their core competencies. For example, companies that specialize in business-to-business contracts might encounter challenges if they start selling directly to consumers or if they apply for government contracts.

Ready, set, restructure

Restructuring a business in today's volatile market conditions is no easy task. It's critical for management to keep their eyes on developing issues and discuss them with people inside and outside the organization. A financial professional can provide objective insight based on real-world experience and a keen understanding of the latest tax and accounting rules. Their expertise can help small businesses minimize risk factors, return to financial stability and build long-term value. ■

Handle financial testimony by lay witnesses with care

A lay witness is a person who has observed certain events and testifies on what he or she saw. In commercial litigation, it's not unusual for company owners, CFOs or other executives to testify as so-called "lay witnesses." But when these witnesses testify on complex financial or valuation issues, there's a risk that their testimony will be found inadmissible as opinion that requires a qualified expert.

Toeing a fine line

Typically, courts make a distinction between *presenting* financial data, which lay people may do, and *interpreting* that data, which is reserved for expert witnesses. Layperson testimony that crosses over into expert witness territory is at risk of being excluded from evidence.

Under Rule 701 of the Federal Rules of Evidence (FRE), a nonexpert's opinion is limited to one that's:

- Rationally based on the perception of the witness,
- Helpful to a clear understanding of the witness's testimony or the determination of a fact at issue, and
- Not based on scientific, technical or other specialized knowledge within the scope of Rule 702, which governs expert testimony.

specialized knowledge within the realm of an expert, but because of the particularized knowledge that the witness has by virtue of his or her position in the business."

For example, in *United States ex rel. Technica, LLC v. Carolina Cas. Ins. Co.*, the company's CEO was allowed to testify as a lay witness regarding the reasonableness of re-rental charges for equipment. The federal court determined that the executive had "particularized knowledge gained from years of experience within his field."

The testimony of a layperson may be disallowed if he or she doesn't possess the required knowledge to testify on the particular subject. Additionally, a witness's testimony may be excluded if he or she qualifies as an expert — for example, the witness is a CPA or credentialed business valuation professional — but wasn't disclosed as such.

By contrast, *expert* witnesses may help the trier of fact understand complex scientific, technical or other specialized matters. Their opinions are deemed reliable if they 1) are based on sufficient facts or data, and 2) stem from principles and methods that have been tried and tested over several years. Novel theories and techniques pose a problem because there's limited research and data to support them.

Qualifying for an exception

The opinions of lay witnesses on financial matters may be allowed in certain situations, however. According to the FRE Advisory Committee's notes, "Most courts have permitted the owner or officer of a business to testify to the value or projected profits of the business, without the necessity of qualifying the witness as an accountant, appraiser, or similar expert. … Such opinion testimony is admitted not because of experience, training or

But when testimony requires more-complex financial or valuation knowledge, courts are likely to require a qualified outside expert. For example, in *Ruhr v. Immtech International, Inc.*, the court rejected testimony from the plaintiff's president regarding lost profits because it involved a new product in a complex market. These financial matters were deemed to be outside of the president's personal knowledge or perception.

The testimony of a layperson may be disallowed if he or she doesn't possess the required knowledge to testify on the particular subject.

Consider outside expertise

Exclusion of testimony related to financial matters can destroy your case in commercial litigation. So, err on the side of caution by hiring a credentialed financial expert to provide opinions on lost profits, economic damages and value. These complex matters often require more specialized knowledge or perception than an owner or executive can provide. ■

Optical Works and Logistics v. Sentinel Insurance Company

Using financial experts to support business interruption claims

As a result of pandemic-related shutdowns, many businesses have filed claims under their business interruption insurance policies. These claims have resulted in litigation over the scope of coverage and the meaning of key policy terms. A recent case demonstrates the importance of using a financial expert to determine losses when making these claims.

What's covered, what's not

Some business interruption policies expressly cover or exclude losses caused by viruses or pandemics. But the language of most policies is less clear.

During COVID-19-related claims litigation, questions have been raised about whether coverage is limited to interruptions caused by *physical* losses — and, if so, whether the potential presence of a virus on the insured premises constitutes physical damage. Alternatively, pandemic-related shutdowns may fall within the scope of policies containing a civil authority clause. Such clauses cover losses incurred when an order of a civil or military authority impedes access to business property.

The existence and extent of the insured's losses may also be disputed in COVID-19-related claims. Involving financial experts early in these cases can help the parties support or rebut claimed losses.

Case in point

A recent U.S. District Court case shows how a financial expert can help support business interruption claims. In *Optical Works and Logistics v. Sentinel Insurance Company*, the insured was an optical media replication start-up. It filed a business interruption claim after a tropical storm caused damage to its equipment and building.

The insurance provider denied the claim. So, the company filed suit, alleging, based on estimates made by an independent financial expert, that its losses could have been only $50,000 to $75,000 had the insurer provided coverage quickly. Instead, the expert estimated that the company's losses had mushroomed to over $4 million, rendering it insolvent.

The insurance provider moved for summary judgment on multiple grounds. However, the court denied the motion, finding that several disputed material facts required a trier-of-fact to decide the claim's merits.

For example, the insurance provider argued that the start-up offered no evidence that it incurred expenses before or after the storm. But the court emphasized that the company hired an outside expert to project the expenses it would have incurred had it continued to operate after prompt payment of its claim.

Experts add value

Though *Optical Works* is a pre-pandemic case, it illustrates the critical role experts can play in the early stages of business interruption claims litigation. Using an independent expert can lend credibility to estimated losses and prevent a court from dismissing a claim simply because it's not supported by objective research and analysis. ■

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