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# valuation & litigation briefing

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**Experts expect the  
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Getting  
the most  
from your  
**expert  
witness**

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# Getting the most from your expert witness

**P**reparing a valuation expert witness for trial or deposition is one of the most difficult tasks in civil litigation. The time and effort an attorney devotes to preparing an expert to give testimony vary from a short telephone conversation to an all-day meeting.

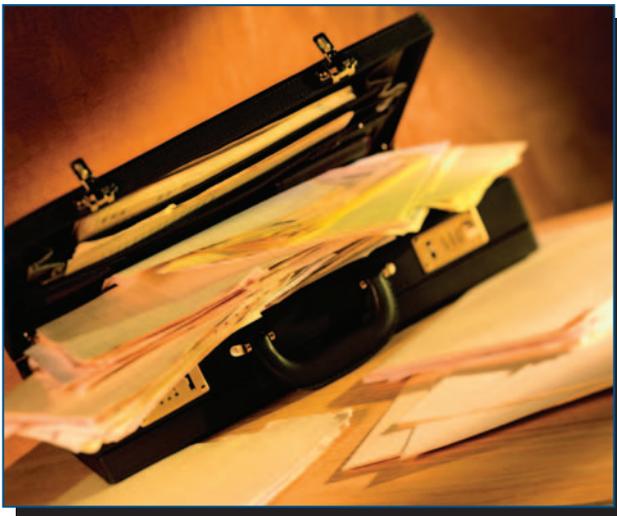
Of course, the length of the preparation is related to the complexity of the case, the role of the expert, and the issues and money at stake. Here's a closer look at some points to keep in mind when preparing an expert for trial.

## 4 focal points

Attorneys need to consider the following four areas of expert testimony to ensure the expert witness is effective at trial.

**1** *Be aware of prior statements.* Make sure you know whether your expert's current opinions are consistent with his or her past work on similar cases. Consistency is usually a direct result of following appropriate standards, professional guidelines and sound practices. Inconsistent statements on the part of your expert may be a weakness opposing counsel will pounce on.

Some valuation experts routinely destroy documents after a certain interval, but this can be problematic.



For one thing, copies of the documents may be in existence elsewhere — and an expert should be able to review such documents readily, on his or her own terms, rather than be confronted with them unexpectedly.

In addition, the attorney needs to inform the expert what, if anything, to bring to a deposition, hearing or trial. This might include copies of documents already produced to the other side, such as the valuation report, documents that back up the report or items the report cites. It may also include documents not yet produced that the expert plans to refer to in support of his or her opinions.

**2** *Understand opposing views.* Someone is bound to disagree with your expert's opinions. But the key for an expert is to connect his or her valuation opinions with the case at hand.

The expert witness needs to show the judge and jury why a particular expert opinion applies here. This may also involve showing why the opposing expert's views:

- Aren't relevant to this case,
- Reveal that the expert is unfamiliar with the plaintiff's industry, or
- Don't even pertain to the business under discussion.

**3** *Be aware of the opposing counsel and expert's style and potential testimony.* You and your expert witness may not be familiar with the style of the opposing attorney. You may not be able to predict whether opposing counsel will be polite, arrogant or condescending. Will opposing counsel pose questions crisply or engage in long prefatory statements before getting to the actual question? The manner in which questions are asked can affect how a judge or jury perceives your expert's testimony.

Understanding the opposing expert's testimony and report (if any) is — or should be — an important part of your expert's work. In addition to clarifying his or her own financial analyses, your valuator can also

critique the opposing expert's report — either formally in a rebuttal report or informally in a verbal discussion or a memo format.

Your expert's critique will expose the other side's technical flaws. You may want to ask your expert to prepare deposition and trial questions for the opposing expert.

Your expert witness also needs to be familiar with, and prepared to respond to, questions about the opposing expert's opinions during a deposition. Your valuator can review the opposing expert's deposition transcript before trial to point out any weaknesses or inconsistencies with the expert's written report.

Another valuable piece of information from the opposition is their expert's work paper file. Time and money permitting, ask your valuator to inspect the other expert's files to uncover the documents reviewed, assumptions made and other underlying details of the valuator's work. This step can be especially fruitful if the valuator's report is brief, vague or hard to follow.

**4 General credibility.** The expert should have a history of serving on both sides of various cases to avoid being labeled either a plaintiff's expert or a defendant's expert.

Don't unintentionally sacrifice your valuator's independence. Judges draw a fine line between advocacy and independence. If you overuse your expert's consulting

### Your ace in the hole

A valuation expert can provide invaluable service as an unbiased consultant during discussions with the opposition. For instance, many valuers become invaluable impartial analysts during heated settlement talks between divorcing spouses.

Because they're not emotionally involved and have nothing to gain (or lose) in the discussion, they can help keep the discussion focused on the case's financial aspects and the equitable distribution of the marital estate. Valuators often help attorneys settle cases before going to court, thus avoiding the time and expense of trial.

services, the judge may consider him or her an advocate rather than an independent outsider.

Consider engaging two valuation professionals: one as expert witness, and another as consultant. An expert's impartiality is essential to his or her credibility before the judge and jury.

### Work it out

To get the most out of your expert, take the time to work with him or her. Get to know the expert's methodologies, strengths and weaknesses, and clearly communicate what you expect from him or her. Openness between expert and attorney is a must. The key is to work as a team without impairing the expert's independence or objectivity. □

## Consider less obvious value indicators

**V**aluators consider more than just a company's financial statements when quantifying its value. Other less obvious items — such as buy-sell agreements, personal loan applications, previous valuations and purchase offers — can also provide evidence of value. Here are some important value factors that may be waiting in the wings to significantly affect your clients' situation.

### Bridging the gap

A company's value is often contentious, especially in litigation. When the parties hire valuers, their analyses are usually mathematically complicated and rely heavily on subjective adjustments and estimates. If the experts' value conclusions differ materially, the valuers are often seen as "hired guns" — biased toward the specific value that supports their individual client's case.

Fortunately, litigating parties can sometimes turn to less obvious — but more objective — value indicators to reconcile their differences. Among the most common nonfinancial value indicators are buy-sell agreements, owners' life insurance coverage, personal loan applications, previous valuations, purchase offers and prior transactions.

Although these items don't usually preclude the need for a valuation professional, they can serve as reasonableness tests or to support or refute value conclusions.

### Determining the item's relevance

Shareholders often protect their business interests with buy-sell agreements that contain valuation formulas to be used on a shareholder's death or termination. Some detailed buy-sell agreements may even specify whether valuation discounts apply and, if so, how much. But if a buy-sell agreement has been superseded or is otherwise outdated, it may not be as relevant to current market values.

Life insurance coverage can provide another useful value indicator. When selecting adequate life insurance coverage amounts, most companies estimate the costs of buying out the shareholder and of losing a key individual. To the extent that coverage was arbitrarily selected or chosen under dissimilar business conditions, however, it should be viewed with caution.

In shareholder disputes and marital dissolutions, personal loan applications can be subpoenaed to provide evidence of a business interest's value. When borrowers list personal

assets on loan applications, they want to appear as credit-worthy as possible.

Conversely, when buying out another shareholder or obtaining a divorce, shareholders have an incentive to undervalue their business interests. When the amounts shown on loan applications and valuation reports differ substantially, it should raise questions.

Finally, arm's-length prior stock transactions and offers to buy the company (or a portion of it) can shed light on a company's value. The courts are especially fond of relying on prior transaction data. For these items to be useful, they should occur within a reasonable time frame and involve unrelated, credible buyers.

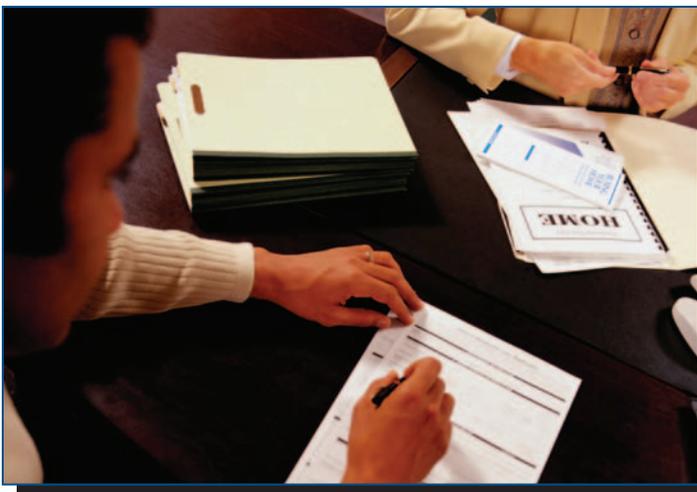
The size and rights of the business interests also should be comparable. For example, the 1985 sale of a 1% non-voting interest would probably not provide an especially meaningful indicator of the current value of a 99% voting interest in the same company. For offers that never materialized, the reason the deal fell through may bear on its usefulness.

Also beware of strategic buyers that offer substantial premiums for buyer-specific synergies — their offers may not truly be indicative of fair market value, if that is the standard under which the current value is to be determined.

Along these same lines, previous valuation reports can provide insight into a company's value. Again, comparability and timeliness are imperative. For instance, a gift tax valuation prepared when a shareholder conveyed a minority interest to his son may not be relevant when estimating the fair value of an oppressed shareholder's interest in the same company.

### Attorneys act as gatekeepers

Most valuation reports address these nonfinancial items, but they are sometimes overlooked, unavailable — or withheld by the client. As a safeguard, attorneys should inquire about the existence and relevance of these important items. Attorneys should also keep valuers "in the know" when these indicators make an appearance. This vigilance will pay off in more successful cases. □



# What's normal?

## How normalized financial statements affect value

**T**he debate rages on. Those in the financial community continue to weigh the pros and cons of adjusting closely held companies' financial statements for valuation purposes.

On the one hand, the valuation community insists that "normalizing" a company's balance sheet and income statement helps ensure the numbers better reflect reality. The term "normalize" means to remove all unusual, nonrecurring events from the financial statements so they present a clearer picture of the company's normal operations.

*Related-party transactions may include excessive executive compensation and perks, loans to related parties or family members, or other transactions not reflecting arm's-length bargaining.*

On the other hand, many of these changes to the books don't meet generally accepted accounting principles (GAAP). So the accounting community insists on upholding GAAP standards.

The question is: Should valuation professionals make non-GAAP adjustments to financial statements? Further, what is the nature of these changes and why do valuers make them?

### To GAAP or not to GAAP

First, let's look at some examples of non-GAAP adjustments that valuation consultants often make. For instance, a valuator might:

**Remove unusual gains or losses appearing on the income statement to show a more accurate picture of earnings.** Unusual events can skew the real picture.

**Remove the effects of discontinued operations from the income statement because these entries tend to**

**significantly skew earnings and operating results.** A prospective buyer of the company would want to view the company without the effects of a no-longer-existing operation contaminating operating results.

**Remove the effects of related-party transactions from operating results so that the valuator can determine the company's true earning power.** These related-party transactions may include excessive executive compensation and perks, loans made to related parties or family members, discretionary expenses or other transactions not reflecting arm's-length bargaining between parties.

**Make adjustments to restate data on a different basis of accounting.** A common adjustment in this category is the last-in, first-out (LIFO) adjustment to inventory. Reversing the LIFO adjustment can often increase income significantly. Another example is reversing the deferred tax entry, which can significantly affect the balance sheet and the income statement.

### Quality or quantity?

Even though valuers need to make normalizing adjustments in determining a company's value, the underlying assets' quality also plays a role in the overall value determination. A marketable majority interest in an asset held by a partnership is more valuable than an unmarketable minority interest. The quality of the underlying assets is, therefore, an important and appropriate issue to study. This is true even though it's the partnership interest that is actually being valued.

**Remove unusual, one-time events from operating results to normalize operations.** These may include uninsured flood damage, insurance proceeds from the death of a key person or a repair bill on a major piece

of equipment. Leaving these anomalous events in place can distort the company's earning capabilities.

**Scrutinize nonoperating assets to determine their business purpose.** For example, consider a company-owned airplane. Suppose the company has no remote operations, no need for travel and, therefore, absolutely no need for an airplane. The valuation consultant should quantify and remove that asset's costs from consideration in the earnings stream. This will enable him or her to determine the company's true earning capabilities.

In another example, suppose a company owns an office building — but doesn't use the building in any of its operations. Further, the company doesn't even inhabit the building. This building is obviously a nonoperating asset. It has no redeeming business purpose vis-à-vis the stated mission of the company.

In this case, the valuator needs to remove the asset from the books to normalize operations and obtain an accurate picture of the company's financial status.

**Evaluate use of depreciation and amortization.** A company should determine depreciation and amortization of its fixed or intangible assets by allocating the cost over the estimated lives of the assets. But some businesses use lives and methods that have little, if any, relation to an asset's economic use and reduction in value.

For example, a company may use accelerated tax methods to depreciate its fixed assets. These methods may allow it to depreciate equipment over five to seven years — even though it may use the asset for 10 to 15 years.

#### A clear picture

The examples go on and on. Clearly, these types of normalizing adjustments

are essential to the valuation process. After all, valutors are trying to determine what adjustments are necessary to ensure their business valuations accurately reflect fair market value. They may have to adjust the company's historical results so those results better represent the "anticipated" and "representative" benefits that an investor may expect.

Keep in mind that value is a future concept. In addition, value only exists when a company uses its assets — either by operating or liquidating them. If the company is unable to exploit its assets in the future, it has no future returns — and hence, no value.

But when deviating from GAAP, a valuation professional's experience and judgment are paramount. □

### Seeing through the smoke and mirrors

Normalizing a company's earnings involves more than merely reading the company's financial statements. It requires detailed analysis as well as an understanding of the company's current and future operations.

For example, sometimes owners use discretionary adjustments, such as perquisites and benefits, to disguise a company's true costs. These expenses can be difficult to uncover because of "creative accounting," such as burying them in payroll taxes and other employee benefits or "miscellaneous operating expenses."

Benefits may consist of:

- Pension/profit-sharing/401(k) matching,
- Auto expenses (lease payments, gasoline, insurance, and repairs and maintenance),
- Insurance (life, disability and health),
- Travel and entertainment (country club dues and costs, vacations, sporting event tickets, personal meals, and other personal expenses),
- Professional fees (financial planners, legal and accounting), and
- Utilities (cell phones, pagers and long-distance charges).

Owners may present these as reasonable and necessary business expenses.

## Experts expect the unexpected in court

Valuators who have spent years in the trenches — particularly those who have had many occasions to serve as expert witnesses — have learned to expect the unexpected in the courtroom. The always unpredictable mix of personalities — including those of the litigants, the attorneys, the judge and the jurors — can lead to surprising and entertaining events during trial.

### Anecdotal evidence

Tom W., a valuation expert, arrived at the courthouse at noon on Thursday, just in time to meet with the attorneys for lunch in the courthouse cafeteria. His testimony was scheduled to start at 1:30. He had hoped to spend a short time with the attorneys during lunch to discuss the highlights of his anticipated testimony and the opinions that he was to render.

One of the attorneys greeted him and noted, “Tom, you are wearing the right colors.” She followed up with, “The jury decided that today would be red, white and blue day.” Tom responded by telling her that he always wears red, white and blue to court. She then advised him that “last Thursday was Hawaiian shirt day. All of the jurors dressed in Hawaiian shirts.”

This was Tom’s first signal that the jury had passed the point of no return. They were looking for novel ways to entertain themselves, and most important, they were probably no longer listening to the evidence.

Tom wondered whether he would be sufficiently interesting to the jurors to hold their attention. Could the economic damages study that he was to present be nearly as entertaining as the ingenuity percolating in the jurors’ minds? He also wondered whether the jurors (in violation of the court’s admonitions) had already reached their verdict. Tom asked himself if the attorneys or the client expected him to bring the focus of the jurors back to the evidence being presented at trial.

### Prepare and communicate

Tom decided not to change his presentation in an attempt to make it more amusing or enjoyable. His experience directed him to focus most carefully on the jurors and their nonverbal communication — their facial expressions, smiles, nods and body language.

Experts learn that preparation and communication are critical. For instance, in preparing to give testimony, experts typically:

- Review thousands of documents,
- Read transcripts,
- Interpret the facts,
- Research and analyze the data,
- Respond to the opposing expert’s analysis, and
- Prepare color charts with multiple overlays and PowerPoint® presentations.

All of these actions can strengthen expert testimony and help persuade an inattentive and distracted jury.



# J.L. PIERSON & CO. LLC

## BUSINESS VALUATION AND APPRAISAL

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J.L. Pierson is an Accredited Senior Appraiser designated by the American Society of Appraisers (ASA) in the Business Valuation discipline. He specializes in business valuation for closely held businesses, family limited partnerships (FLPs), Limited Liability Companies (LLCs) and professional corporations. Valuations are performed for investment, estate planning, financial reporting, corporate insolvency, gift/estate tax and income tax purposes. This type of valuation work often involves discounts that must be based on reasoned and well-documented judgment — not a formula or software package — that is fully consistent with case law.

J.L. Pierson specializes in Business Valuation and appraisal only, including such projects as:

- Valuation of interests in FLPs and LLCs holding marketable securities, real estate or other investments including partnership interests.
- Valuation of professional practices, including accounting, medical and law, often for marital dissolution cases, earn-outs and other purposes.
- Succession planning, gift and estate planning, and asset protection for the closely held business in all industries.
- Determination of the appropriate corporate development strategy for enhanced business value including exit strategy.

We also provide valuation and litigation support services for a broad range of other purposes, including:

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- Lost profits/Business Interruption: Damage calculations and other litigation claims.
- Buy/Sell agreements.
- Dissenting & Oppressed shareholder suits.
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