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EXPERT

AICPA Newsletter for Providers of Business Valuation, Forensic, & Litigation Services

Winter 2010

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## A New Newsletter for FVS Section Members

Beginning in June, *CPA Expert* and *Focus* newsletters and the *ABV e-Alert* will be replaced by

**Forensics and Valuation Expert**
*Issues, Cases, Practice Management Tips and News for FVS Section Members*

The 12-page monthly newsletter will be distributed electronically to all FVS Section members as a benefit of section membership. Paid subscriptions to *CPA Expert* will automatically be converted to free-of-charge subscriptions to the new publication. A primary reason for consolidating the newsletters into one monthly publication is to respond to FVS Section members' comments that they receive too many communications.

As indicated by the newsletter title and the tag line below it, the new newsletter will provide information and guidance on technical and management topics, noteworthy current case law,

*continued on page 2*

# EFFECTIVE FVS MARKETING—INSIGHTS FROM A SURVEY

By Everett P. Harry, CPA/CFF

I conducted a survey of attorneys about methods they use to identify potential experts for hire. I excluded questions about their evaluation of experts specifically named by opposing counsel. I did so because I presumed that in this situation, an attorney's investigative approaches and the resources reviewed varied significantly from initial efforts made to find an expert without having a specific name in mind.

I asked how often (from "rarely" to "almost always") attorneys identify expert candidates from personal experience, referrals, printed resources, the Internet, and expert search firms. I present my findings in table 1 on page 2. I was not surprised by the relatively average rankings for the various expert identification resources, but I did not expect the magnitude of the divergence between some of the average responses by resource category. Further, given comments provided by some survey respondents, as well as their responses to follow-up questioning, the divergences may be more pronounced for selecting forensic and valuation services (FVS) experts. That is, attorneys often have personal knowledge of available FVS experts but tend to expand searches to more information sources, including paid searches when, for example, what is at issue relates to a narrow industry or academic specialty.

I based the survey sample on my attorney contact list, which primarily but not exclusively reflects West Coast lawyers who practice commercial litigation. Yet, I found no significant difference in responses based on attorney years of experience or primary practice specialty. Consequently, I believe my findings provide meaningful information for CPA experts' consideration.

### THE SURVEY MIRROR AND LIMITED RESOURCES

Although my survey was directed to lawyers and focused on how they find experts, my findings are important to experts marketing FVS. Effective FVS marketing should mirror and complement attorney resource preferences for finding experts.

All of us face constraints on our personal time availability and most of us have limited financial resources, especially for FVS marketing. We need to choose our strategies with care and strive to optimize our investments. I appreciate that many professional undertakings have some practice development potential, but not all have the same expected cost-benefit basis.

### ATTORNEY PERSONAL EXPERIENCE AND REFERRALS

Attorneys most often find experts based upon their personal experience and referrals from within their firms or from other professionals. These three approaches have common threads—personal contact and

*continued from page 1*

and news about FVS Membership Section resources, benefits, and events.

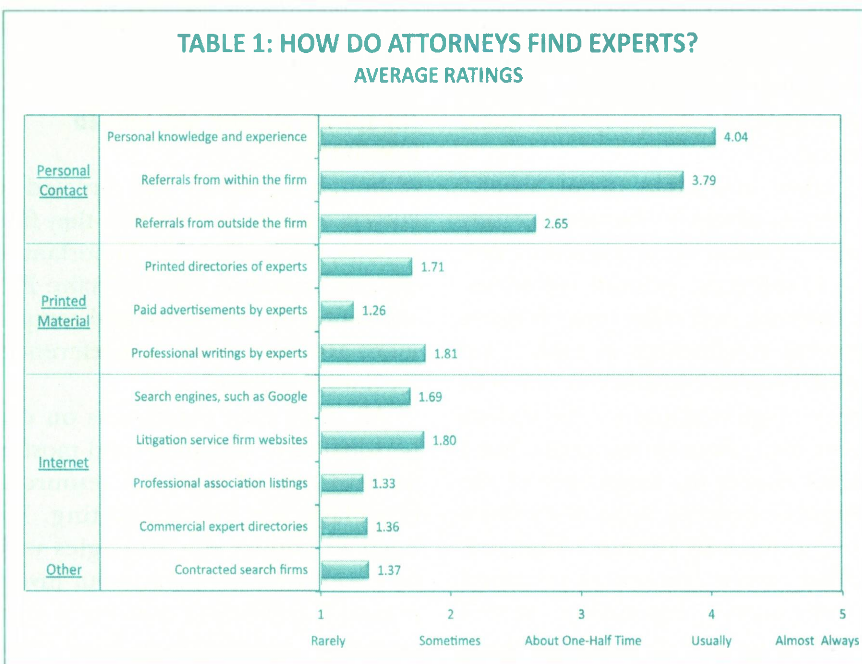
You'll be alerted by email when each issue is posted to the FVS Web site and provided with a link to each issue. To make sure we have your current email address, go to *www.aicpa.org*, log in, and update your profile. If you encounter problems logging in, call AICPA customer service at 888-777-7077 or email service@aicpa.org.

pre-engagement validation. Either the attorney had prior positive exposure to an expert or the attorney trusts the advice of another professional. Litigation is risky. An attorney strives to minimize risk by engaging an expert who performs effectively throughout the retention period, especially by delivering effective, competent testimony in deposition or at trial. As a result, attorneys understandably tend to rely on their own knowledge or respected referrals before turning to generally available expert identification resources.

The FVS marketing implication is clear: An expert should nurture and strengthen existing attorney contacts to obtain repeat engagements or referrals. This advice may seem self-evident; nevertheless, many FVS professionals give this approach less emphasis than warranted. Although an expert does excellent work at a fair price for clients, he or she should not assume that clients will eventually call again. Litigation and business lawyers often need an FVS expert only now and then. Without malice, they might simply forget an expert if months or years pass between points of need.

If you've already proven your skills as an expert, don't let attorneys' memories of you fade. Marketing to lawyer contacts need not be expensive or inordinately time consuming. For example, you can reach all of your key attorney contacts by mailing holiday cards, firm announcements featuring your name, copies of articles authored, or a custom newsletter about your practice. Accomplished at least twice a year, these marketing efforts remind contacts of your name and availability. You might want to include FVS and other known experts in these practice development efforts because they also are potential referral sources.

Direct marketing to individual attorneys makes sense when you have a prior positive relationship, and the effort can help build a long lasting bond. Of course, selectivity is recommended given time limitations. Some FVS professionals seek opportunities to meet new attorneys and present their credentials, even using a business development specialist to arrange such meetings. However, despite your best presentation skills, chances of starting a business relationship diminish unless you have a prior working relationship with an attorney or arrive based upon a strong referral that validates your competence.




## BROADCAST MARKETING

The survey demonstrated that marketing to a wide audience composed

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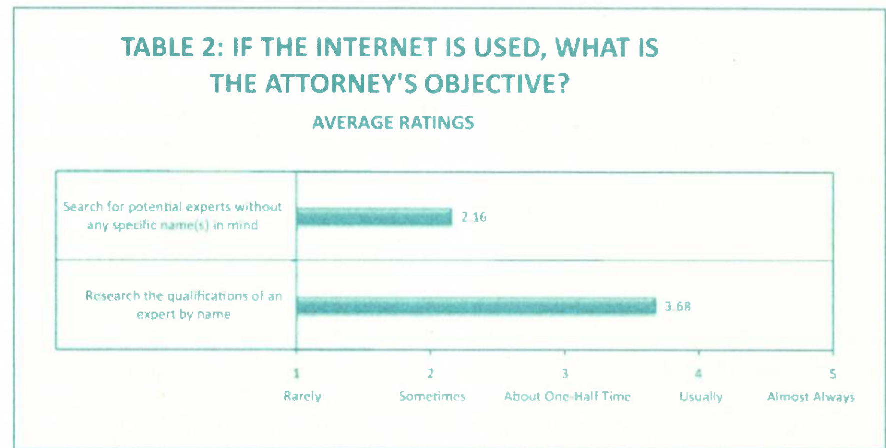
primarily of attorneys not personally known to you is only marginally effective. For example, paid advertisements by experts and hard copy expert directory listings ranked quite low among the resources attorneys use to find potential experts. Advertisements or listings may describe your experiences and credentials, but do not provide any personalized assurance that you are a thoroughly effective consulting or testifying expert when engaged. Of course, paid advertisements and printed directory listings do contribute somewhat to general name recognition, but usually are not the primary drivers for building and expanding an FVS practice.

## DISTINGUISHING BETWEEN MARKETING AND CREDENTIALING ACTIVITIES

The FVS expert should distinguish between credentialing and marketing activities for business development and sales plans. Credentialing efforts include participating in professional society activities, especially attaining leadership positions; writing professional articles, books, and other publications; and speaking at seminars and conferences. These undertakings certainly help persuade potential clients of experts' capability and also augment their credentials, thereby enhancing the probability of their acceptance as experts in court. Nevertheless, the survey and my experience do not indicate that these credentialing activities are significant affirmative marketing tools. In more than 30 years of practice, I have received only a few calls prompted by an attorney's reading one of my writings. Perhaps most attorneys simply don't regularly read CPA publications or, similarly, gain independent awareness of the leaders in professional societies, practice specialties, or industry organizations.

I believe in contributing time and service to our profession. However, I do not undertake these activities with an expectation of generating material amounts of business. Nevertheless, I am confident that my efforts have helped to build my expertise and reputation.




## INTERNET-BASED RESOURCES

Over the last decade, the Internet has made remarkable progress in providing information resources and other services to the general public, as well as to attorneys and FVS experts. Attorneys now can research case law or file court papers online without leaving their offices. Likewise, experts seldom visit a physical library for case research, including the gathering of economic statistics or performing industry analyses. Yet, the survey indicates that attorneys are not yet using the Internet as a common tool to find experts for their cases although, for example, some experts are paying significant annual fees for premium listings on Internet Web sites providing expert directories.

I studied many Web sites that offer expert directories and concluded that the Internet is not inherently flawed as a means to communicate information about expert candidates. Rather, online expert directories now have certain disadvantages for attorneys seeking to find an expert to engage. The disadvantages include the following:

- *Pay to view*—Many Web sites require payment of significant fees in order to explore lists of expert candidates. Some Web sites present the number of experts in the database by discrete practice area or industry, but allow only paying site members to view individual experts' names and credentials. These are grab bag approaches—pay first and take your chances.
- *Far from complete expert databases*—Some Internet expert directories advertise that they list tens of thousands of individuals in their databases, which can be searched for free. I tested such sites by searching under categories like "economic damages" and "Northern California" and was presented with fewer than a dozen names per site. Just for CPAs (economists also provide this service), the California Society of CPAs has hundreds of members in its litigation sections, many of whom are domiciled around the San Francisco Bay Area. Further, the search results for my geographic area did not include CPAs or others whom I know are nationally recognized for expertise in economic damages.
- *Lack of comparative information*—Current Internet expert directories provide varying levels of fact-based detail about prospective experts' qualifications and experiences, but do not offer information to help lawyers compare experts in terms of potential engagement performance quality.

Internet expert directories have potential; for example, consider what

Martindale Hubbell has done regarding lawyers. In the Internet's current state, however, attorneys rarely use it to find experts. On the other hand, attorneys do use Internet searches once specific names become known whether by referral, legal disclosure, or other means. Table 2 on page 3 supports these observations. Therefore, you can supplement your FVS marketing efforts through relatively low cost Internet-related efforts such as the following:

- Establish a Web site if you don't have one. The initial cost can be controlled and should benefit your entire practice, not just FVS services.
- Ensure that general Web searches using certain key terms will point to your Web site.
- Provide a general narrative or basic résumé about your credentials, qualifications, and experiences on your Web site.
- Provide copies of or links to selected writings that demonstrate your expertise related to FVS.
- Describe your practice, credentials, experiences, and abilities only in terms that you are comfortable defending at deposition or trial.

It takes years of effort to build a viable FVS practice because new business often flows from past positive experiences with attorneys who then re-engage you or provide referrals to other lawyers. Thus, FVS marketing should focus on your personal contact list of attorneys. Your comprehensive business development plan, however, likely will entail a variety of other strategies and efforts, which you should pursue at reasonable cost and with realistic expectations.

**Everett P. Harry, CPA/CFF, is a partner with Harry Torchiana LLP, San Francisco. He has served on AICPA committees and AICPA Council.**

# WHAT YOU DON'T KNOW CAN HURT YOU IN COURT

By Ronald L. Seigneur, MBA, CVA, CPA/ABV/CFF

*A review of* The Comprehensive Guide to Lost Profits Damages for Experts and Attorneys *by Nancy Fannon, CPA/ABV, ASA, MCBA, author and editor (Business Valuation Resources,* 2010), 756 pages; (ISBN 978-935081-11-1).

As its title implies, *The Comprehensive Guide to Lost Profits Damages for Experts and Attorneys* is truly a wide-ranging and all inclusive resource for attorneys making claims for losses and experts seeking guidance on how to measure the financial impact of those losses. In addition to contributions by Nancy Fannon, the guide includes contributions by 17 financial experts and attorneys who practice in the area of lost profits. A panel of 11 technical reviewers vetted the book before publication. The book includes access to an online version, available in both searchable digital-reader and downloadable PDF formats.

The guide has 19 chapters and extensive appendices, including court case abstracts, all word-searchable on the online version. Access to the online version of the guide provides quick and easy access to finding key information for damages analysis. A search of the word "yardstick," for example, turned up 72 matches, spanning methodology, application, expert exclusions, and case law.

The guide provides guidance for both experienced and novice experts. From chapter 1 on, it follows a case from initiation and explanations of the legal basis on which lost profits claims are made to materials covering the process of a claim. These materials include procedure, evidentiary matters, discovery, and spoliation of evidence, including draft reports. Chapter 2 by Michael A. Crain, CPA/ABV, ASA, CFA, CFE, is about "Professional Standards for Experts," providing guiding standards for experts in litigation matters. The appendices also include background material that experts should be aware of, including the Federal Rules of Evidence, Rules of Civil Procedure, and sample scheduling orders. Chapter 5, authored by James O'Brien, CPA, CFE, and Robert P. Gray, CPA/ABV/CFF, CFE, FACFEI, provides an excellent overview of the recognized methods and procedures used in lost profits calculations.

The development of lost profits claims is a creature of the courts. Consequently, the materials on lost profits damages calculations focus heavily on the development of lost profits damages theory by reference to case law, pointing out jurisdictional differences. The guide has extensive references to lost profits damages cases and provides abstracts of many of the guiding cases presented in the appendices. The full text versions of lost profits cases can be accessed on the online resource center.

## EXCLUSION OF EXPERTS

The guide thoroughly covers lost profits damages development and theory, and, importantly, evidentiary requirements. Although appropriate evidence to support a claim has always been an important part of the expert's calculation, as electronic

evidence rules have come into play, the role of expert has come under increasing scrutiny. Furthermore, exclusions of experts from testifying have exploded.

For this reason, experts and attorneys alike will find the chapter on exclusions of experts in lost profits cases is something they shouldn't miss. Written by contributor Jonathan Dunitz, Esq., the chapter covers the basis for admitting or excluding an expert and provides cases and commentary on lost profits exclusions of experts for each federal circuit and all 50 states. The appendix also includes an extensive paper by Professor Robert M. Lloyd, which reviews exclusions of experts in lost profits cases. In reading these materials, experts will truly find that what you don't know can hurt you. Clearly, the courts have set the bar high for experts and have become increasingly willing to let parties know when they have missed the mark.

The guide has special interest chapters. Three such chapters cover IP losses related to patents, copyrights, and trademarks. The guide also covers special areas of lost profits, including automobile dealerships, physician practices, construction claims, government contracts, and insurance claims.

CPAs who are contributing authors include Stephen Bowden, CPA; Michael A. Crain, CPA/ABV, ASA, CFA, CFE; Mark O. Dietrich, CPA/ABV; Robert Gray, CPA/ABV, CFF, CFE, FACFEI; Thomas Burrage, CPA/ABV; Richard Bero, CPA/ABV, CVA, CLP, CFF; Richard Hoffman, CPA/ABV; Colin Johns, CPA, CFF, CFE, CA; Michael Kaplan, CPA/ABV, CVA, CFFA; Patrick McGeehin, CPA; Greg A. McKinnon, CPA, CFF, CMA; James O'Brien, CPA, CFF; and Timothy York, CPA/ABV. In addition, numerous attorneys participated as contributing authors and others as technical reviewers.

The guide's editor and contributor Nancy Fannon owns Fannon Valuation Group, based in Portland, Maine, which offers litigation support, financial analysis, valuation services, and expert testimony. She has more than 20 years of professional experience related to valuation and litigation services and has been qualified as an expert witness in state and federal courts. She is a nationally known expert on lost profits damages, pass-through entity valuation, and the transaction databases and has presented dozens of speeches and authored numerous papers on these and other areas related to valuation and litigation services. She has served as an editorial adviser to *CPA Expert* and several other valuation-related publications, has been a volunteer member of many AICPA committees related to business valuation, and has been honored with many awards for her service to AICPA.

**Ronald L. Seigneur, MBA, CPA/ABV, CVA is partner and valuation specialist with Seigneur Gustafson LLP, Lakewood, CO.**

# INVESTIGATIONS BEST PRACTICES

By Christopher T. McClure, CPA/CFF et al.

Trends related to securities fraud have heightened demand in the marketplace for CPAs with appropriate skills and resources to assist in forensic investigations. Several initiatives by the Securities and Exchange Commission (SEC) and state regulators are driving this need. The initiatives include the following:

- Ponzi scheme investigations (for example, the Madoff and Stanford investigations)
- Pursuit of corporate executives for insider trading or inappropriate financial disclosures
- Subprime mortgage probes
- Foreign Corrupt Practices Act reviews
- Stock option backdating probes

In its 2008 Securities Litigation Study released recently, PricewaterhouseCoopers points out that 210 federal securities class actions were filed in 2008, an increase of 29% above the 163 case filings a year earlier; 48% of all cases were in the financial services sector. The study shows that the SEC and U.S. Department of Justice (DOJ) had an unprecedented number of Ponzi schemes on their radar last year. The SEC tracked 70 Ponzi cases between 2007 and 2008, and the U.S. Commodity Futures Trading Commission reported that it followed twice as many leads to suspected Ponzi cases in 2008 than in 2007. The result was prosecution in 15 cases.

These trends present an opportunity to review some best practices in conducting white collar investigations that may be of help to CPAs. Whether a CPA is an experienced sleuth or embarking on his or her first investigative engagement, these tips and techniques can be useful in planning, executing, and reporting the process and its results. They will also facilitate discussions with a client, the company, and other interested parties such as auditors and regulatory agencies.

### RETENTION AND ENGAGEMENT INITIATION

At the outset of an investigation, it is critical for the CPA to confirm exactly to whom and how he or she will be reporting. Given the complexities and nuances of an investigation, it might be unclear at first whether

the company will use internal or external counsel and whether the board of directors will form a subcommittee to oversee the investigation. The CPA may be asked to perform an independent investigation or may be retained in a consulting role to assist the board and the executives as they respond to investigative inquiries, manage e-discovery processes, or restate financial statements. Throughout the course of an investigation, many parties are involved (the executives, directors, internal counsel, external counsel, SEC, IRS, state regulators, financial auditors, financial audit forensic accounting personnel, and so on). Therefore, an imperative is that the CPA works proactively with counsel to establish procedures governing acceptable times, methods, and means of communication among the parties to avoid any undue problems. Similarly important is proactive and regular communication regarding fee and expense budgeting because without this communication unanticipated or expanded work steps can have a significant impact on the timing and cost of an investigation.

## PLANNING

The beginning of the investigation is the best time for the CPA to develop a work plan to share with counsel and gain consensus regarding the best path forward. The work plan should outline the key phases of the investigation, the procedures to be employed in each phase, the timing, and the responsible parties. Interviews, document and electronic file review, financial accounting analysis, and results reporting are some of the major phases to consider. The CPA should be prepared to discuss fees and expenses as well as the potential need for third-party vendors to provide copying, scanning, hard drive imaging services, court reporting, and other services. The work plan should also consider the timing and methods for interim progress reporting. Given the heightened sensitivity of most investigations, the preference may be for verbal communication.

## INTERVIEWS

Interviewing relevant executives and other personnel is a key component of investigations and often very informative and enlightening if done diligently. Counsel usually takes the lead role in interviews to establish an appropriate understanding of the privilege that may or may not exist and by whom it may be exercised. Although counsel should present all the relevant legal disclaimers at the inception of every interview, it is important to note that the DOJ has taken the position that an employee can be indicted for obstruction of justice under 18 USC 1512 if he or she lies to private counsel conducting an internal investigation, knowing that his or her statements may be shared with a government agency such as the SEC or DOJ conducting its own investigation[1]. This raises questions about whether counsel should issue a warning and, if witnesses want to seek individual counsel, when should special counsel be prepared to accommodate the request for an adjournment to seek such counsel.

CPAs should confirm with counsel how and when they will participate in the interviews. Counsel may rely heavily on CPAs to prepare and possibly deliver interview questions, especially for those interviewees closely associated with the relevant finance and accounting functions. Witness interviews should be documented in a manner consistent with the attorney work product doctrine[2] and should be prepared containing the substance of each witness interview as close in time to the interview as possible. Multiple interviews of key witnesses are very common.

## DOCUMENT COLLECTION AND REVIEW

Document collection and review is another key step in establishing proper evidence. CPAs should be prepared to search and copy various sources of documentation, which could include paper copies, microfiche, computer hard drives, and corporate network servers and backup tapes. The preponderance of electronic evidence requires significant expertise because of evolving discovery rules, chain of custody concerns, and fear of data loss. CPAs should seek to involve others in their practice or consult with outside experts as needed to confirm that the electronic capture and review process is performed properly. This process generally consists of imaging of local hard drives and network drives to capture files of relevant custodians, processing electronic data to make it available for review, and selecting and implementing a review tool—often Web based. It is critical to establish a well ordered and closely controlled process for obtaining and securing laptops and network tapes while the imaging is performed to ensure the integrity of the process and the chain of custody of the evidence. The population of data for review can consist of email messages, users' files (Word, Excel, PowerPoint, and the like), images, or voice recordings and can range from a few thousand files to tens of millions.

Given the importance the electronic discovery component can play in the overall investigation, the following more specific techniques may be of help:

- Be cognizant of the various parties involved and how they may seek to gain access to the data so that you

1 18 U.S.C. 1512(c), a provision added to the obstruction laws in 2002 by the Corporate and Criminal Fraud Accountability Act, which was enacted as Title VIII of the Sarbanes-Oxley Act, Pub. L. No. 107-204 (2002). Section 1512(c) provides that "[w]hoever corruptly (1) alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding; or (2) otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so, shall be fined under this title or imprisoned not more than 20 years, or both." See *U.S. v. Kumar, No. 04-cr-846* and *U.S. v. Singleton, No. 4:04-cr-514-1*.

2 Information on the Federal Rules of Evidence can be accessed at http://federalevidence.com/taxonomy/term/215.

can plan ahead for multiple copies, mirrored databases, and other approaches to satisfy the needs in a cost effective and efficient manner.

- Avoid costly reworking by gaining consensus at the outset among the various parties to the investigation concerning the following issues:
  - Custodians.
  - Keywords, phrases, and search terms.
  - Time frame.
  - Deduplication variables.[3]
  - Inclusion of email strings.
  - Hosting application and vendor.
  - Process for various levels of review and communication of results.
  - Sharing of data among parties (for example, mirrored databases).
  - Closely track statistics by custodian including gigabytes of data, number of files, relevant hits by search term, and so on.
- Summarize the majority of nonresponsive emails to help parties understand what surfaced from the search terms.

## QUANTITATIVE ANALYSIS

Traditionally, quantitative analysis is the portion of an engagement most often assigned to a CPA. Usually the primary goal is to measure and display the relevant amounts at issue in a way that is understandable to all parties involved. Typical examples of such quantitative analyses include the following:

- Fraudulent revenue recognition transaction listing
- Improper reserve account compilation
- Flow charting of debits and credits to t-accounts involved in fraudulent activity
- Stock option incentive compensation measurement grid

A strong analytical presentation commonly includes the following characteristics:

- *Clarity.* Use common language, define acronyms, and present sources for accounting standards to craft an analysis that will be easily understood and very informative to the client and counsel.
- *Transparency.* To enhance both quality control and interpretation, where possible, employ simple tools (for example, Microsoft Excel) that display data inputs and formulas.
- *Flexibility.* Use flowing formulas and easily changed formats (rather than hard-coded data) to allow for ad hoc reporting and sensitivity analyses.

## QUALITATIVE ANALYSIS

The qualitative analysis stage focuses on the actions of individual witnesses and requires intensive and ongoing interaction with counsel to define the overall goals and the specific steps. The process of determining "who did and knew what and when?" can be challenging and often requires creativity to process the case evidence in the appropriate manner. Chronologies featuring documents, interview notes, electronic discovery, and other case evidence can be very valuable keys. The results of the analysis can form the basis for employee termination, reassignment, training, and other remedial steps. Regulatory agencies are often particularly interested in the results of this stage of the investigation.

## REPORTING

As the evidence review and analyses stages conclude, CPA and counsel move towards crafting a report that communicates to the relevant parties the findings of the investigation. The CPA should confirm with counsel the approach and format for crafting the report. Often, the form of the report is oral because of concerns about a written report getting into the hands of government authorities or plaintiff's counsel. However, the client may insist on a written report, and the CPA should work with counsel to determine the appropriate level of detail to include. The Board of Directors, the SEC, the company's auditors, and other regulatory agencies may request a report of the investigation's findings along with other supporting documentation.

## REMEDIATION PLANS

Remediation plans are commonly presented (oral or written) at the conclusion of the investigation. They typically address the internal control weaknesses identified during the investigation and often include recommendations for hiring, terminating, reassigning, training, and monitoring employees. These plans should be the result of a thorough and careful collaboration by counsel and consultants and communicated in a clear manner to ensure the client can implement the plan.

Investigations are on the rise due to increased SEC enforcement actions in a difficult economy. The authors of this article hopes that the tips and techniques shared here will help CPAs plan and perform their investigative roles with increased awareness and effectiveness. Perhaps the best advice that can be shared is to "expect the unexpected" and thereby overcome the unique challenges of each new investigative engagement.

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3 Deduplication variables refer to the data presented in or with emails that can be used to extract multiple copies of the same emails and reduce the population for review. This could include sender(s), recipient(s), time, day, subject, and so on.

# VALUING EARNOUTS IN UNCERTAIN TIMES

By Brad Pursel, CPA/ABV, CFA, ASA, and Todd Patrick, CFA

*An Overview of FSP FAS 141R Requirements*

The requirements of Financial Accounting Standards Board (FASB) Staff Position (FSP) FAS 141R, *Business Combinations*, related to the valuation of contingent consideration, present new opportunities as well as new challenges for valuation specialists. Although the number of FSP FAS 141R engagements may not increase compared with those under FSP FAS 141, their scope will enlarge if there is contingent consideration. In addition, clients and auditors will have a difficult time understanding and testing the accuracy or reasonableness of the values that analysts derive for contingent considerations (commonly referred to as *earnouts*), especially when complex methods have been used.

It seems unlikely, however, that the need to comply with FSP FAS 141R will have a meaningful impact on the frequency that companies use earnouts in acquisitions. New data analysis, performed for this article, shows that transactions in some industries may entail more earnouts than others, although the current economic environment may be responsible for those differences.

## WHAT ARE EARNOUTS AND WHY ARE THEY USED?

FSP FAS 141R became effective for fiscal years beginning after December 15, 2008. Among its many changes, FSP FAS 141R now requires entities to value earnouts upon acquisition when any overestimates or underestimates of value result in either gains or losses on the income statement.

*Earnouts* are promises by the buyer to pay the seller additional compensation if a performance benchmark is achieved or a hurdle exceeded within a specified period. An unlimited number of earnout structures exist, varying by such factors as the following:

- Financial hurdle (level of revenues; gross profit; earnings before interest, tax, depreciation, and amortization [EBITDA]; and so on) or milestone (U.S. Food and Drug Administration [FDA] product launch approval, and so on);
- Length of earnout period;
- Period-by-period or cumulative earnout hurdle;
- Partial earnout eligibility;
- Capped or uncapped earnout; and
- Call options on earnout by buyer.

When evaluating an earnout, the analyst must have a thorough understanding of the terms to plan the necessary scope of work, fees, and project timeline.

A particular transaction includes earnouts for a number of reasons. Some of the more common objectives seek to

- bridge the gap in perception of value between the buyer and seller;
- motivate sellers who remain in management post-acquisition towards high performance;
- provide a financing tool for buyer; and
- defer taxes for seller.

The first reason may result in increased use of earnouts for the foreseeable future.[1]

## EARNOUT FREQUENCY

Using the Thomson ONE Banker database, we searched transactions that closed during the 5-year period between January 1, 2003, and December 31, 2007, in which the buyer acquired 75% to 100% of the outstanding equity. For additional searches, we varied such criteria as whether contingent consideration was used—the location of buyer and seller; public status; date range; deal size; industry; and so on. The tables on page 9 provide selected search results.

Based on this data and transaction analysis, we drew the following conclusions:

- Consistent with the goal of bridging the buyer's and seller's value expectations, we found that earnouts were more frequently used in transactions when the target was in an industry with relatively higher uncertainty and typically higher intangible asset value (such as the software and biotechnology industries).
- In those industries characterized by relatively less uncertainty and lower intangible asset value (such as the financial and natural resources industries), we found that earnouts were less frequently used.
- Earnouts were generally used more frequently in smaller deals than in larger deals. The biotechnology industry was the exception to this trend, with earnouts used more frequently in larger deals (albeit based upon a relatively small sample size).

In regard to the size of earnout payments relative to overall purchase price, a study of 1985–1999 transactions indicated that, for transactions including an earnout, the average portion of purchase price represented by earnouts ranged from a low of 15 percent in 1999 to a high of 88 percent in 1994.[2] Consistent

1 Brendan J. Radigan and Devin B. Fargnoli, "A Deal Technique for Uncertain Times," *Buyouts Magazine* (Dec. 1, 2008).

2 Robert F. Bruner, "Technical Note on Structuring and Valuing Incentive Payments in M&A Earnouts and Other Contingent Payments to the Seller," Darden Business Publishing (Virginia 2001), Exhibit 1.

| All Transactions | | | | |
|---|---|---|---|---|
| Deal Value Range ($M) | | | | |
| Low | High | All Deals | Earnouts | % of Total |
| 1.0 | 5.0 | 1,565 | 149 | 9.5% |
| 5.1 | 10.0 | 1,153 | 128 | 11.1% |
| 10.1 | 20.0 | 1,405 | 146 | 10.4% |
| 20.1 | 30.0 | 834 | 75 | 9.0% |
| 30.1 | 40.0 | 643 | 67 | 10.4% |
| 40.1 | 50.0 | 499 | 38 | 7.6% |
| 50.1 | 100.0 | 1,373 | 96 | 7.0% |
| 100.1 | 200.0 | 1,250 | 88 | 7.0% |
| 200.1 | 300.0 | 572 | 32 | 5.6% |
| 300.1 | 400.0 | 340 | 15 | 4.4% |
| 400.1 | 500.0 | 239 | 7 | 2.9% |
| 500.1 | 1,000.0 | 493 | 19 | 3.9% |
| | | 10,366 | 860 | 8.3% |

| Financial and Natural Resources Industries | | | | |
|---|---|---|---|---|
| Deal Value Range ($M) | | | | |
| Low | High | All Deals | Earnouts | % of Total |
| 1.0 | 5.0 | 221 | 16 | 7.2% |
| 5.1 | 10.0 | 194 | 6 | 3.1% |
| 10.1 | 20.0 | 316 | 12 | 3.8% |
| 20.1 | 30.0 | 217 | 4 | 1.8% |
| 30.1 | 40.0 | 184 | 8 | 4.3% |
| 40.1 | 50.0 | 130 | 5 | 3.8% |
| 50.1 | 100.0 | 366 | 8 | 2.2% |
| 100.1 | 200.0 | 412 | 12 | 2.9% |
| 200.1 | 300.0 | 169 | 4 | 2.4% |
| 300.1 | 400.0 | 93 | 2 | 2.2% |
| 400.1 | 500.0 | 73 | 1 | 1.4% |
| 500.1 | 1,000.0 | 178 | 8 | 4.5% |
| | | 2,553 | 86 | 3.4% |

| Software Industry | | | | |
|---|---|---|---|---|
| Deal Value Range ($M) | | | | |
| Low | High | All Deals | Earnouts | % of Total |
| 1.0 | 5.0 | 152 | 26 | 17.1% |
| 5.1 | 10.0 | 121 | 19 | 15.7% |
| 10.1 | 20.0 | 109 | 16 | 14.7% |
| 20.1 | 30.0 | 58 | 7 | 12.1% |
| 30.1 | 40.0 | 45 | 5 | 11.1% |
| 40.1 | 50.0 | 37 | 5 | 13.5% |
| 50.1 | 100.0 | 92 | 10 | 10.9% |
| 100.1 | 200.0 | 66 | 6 | 9.1% |
| 200.1 | 300.0 | 37 | 3 | 8.1% |
| 300.1 | 400.0 | 21 | 0 | 0.0% |
| 400.1 | 500.0 | 16 | 1 | 6.3% |
| 500.1 | 1,000.0 | 14 | 0 | 0.0% |
| | | 768 | 98 | 12.8% |

| Biotechnology | | | | |
|---|---|---|---|---|
| Deal Value Range ($M) | | | | |
| Low | High | All Deals | Earnouts | % of Total |
| 1.0 | 5.0 | 19 | 4 | 21.1% |
| 5.1 | 10.0 | 8 | 1 | 12.5% |
| 10.1 | 20.0 | 17 | 0 | 0.0% |
| 20.1 | 30.0 | 11 | 2 | 18.2% |
| 30.1 | 40.0 | 7 | 2 | 28.6% |
| 40.1 | 50.0 | 10 | 2 | 20.0% |
| 50.1 | 100.0 | 10 | 0 | 0.0% |
| 100.1 | 200.0 | 14 | 5 | 35.7% |
| 200.1 | 300.0 | 8 | 2 | 25.0% |
| 300.1 | 400.0 | 6 | 2 | 33.3% |
| 400.1 | 500.0 | 4 | 0 | 0.0% |
| 500.1 | 1,000.0 | 3 | 1 | 33.3% |
| | | 117 | 21 | 17.9% |

with our findings, earnouts during 1985–1999 appear in a fairly small percentage of the overall transaction activity.

Based on this historical analysis, the frequency with which an appraiser will need to value an earnout will depend primarily on the transaction size and target industry. Valuation specialists working on smaller or more technology-intensive industries may confront earnouts far more frequently.

## FAS 141R GUIDANCE

Under FAS 141R, contingent consideration must be valued as of the acquisition date and as of each reporting date thereafter until the liability is settled. Some of the more important aspects of FAS 141R concerning contingent consideration are discussed below.

## INITIAL MEASUREMENT

The FASB's decision to require the valuation of contingent consideration came about because "the delayed recognition of contingent consideration in...previous standards on business combinations was unacceptable." (paragraph B346). Prior standards ignored that the acquirer's agreement to make contingent payments is often the obligating event in business combination transaction. "Although the amount of the future payments the acquirer will make is conditional on future events, the obligation to make them if the specified future events occur is unconditional...Failure to recognize that obligation or right at the acquisition date would not faithfully represent the economic consideration exchanged at the date."

## PERIODIC REMEASUREMENTS

After the initial valuation and recognition of the contingent consideration (in terms of accounting entries, by debiting goodwill and crediting a contingent liability), FSP FAS 141R makes two changes to the measurement of the contingent consideration. First, paragraph 65 states:

> Some changes in the fair value of contingent consideration that the acquirer recognizes after the acquisition date may be the result of additional information about the facts and circumstances that existed at the acquisition date that the acquirer obtained after that date. Such changes are measurement period adjustments in accordance with paragraphs 51-55.

Such measurement period adjustments, which may extend no longer than one year from the acquisition date, would not have an impact on the income statement.

Second, paragraph 65 continues:

> However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price, or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:... [c]ontingent consideration classified as an asset or a liability is remeasured to fair value at each reporting date until the contingency is resolved. The changes in fair value are recognized in earnings....

Therefore, the initial valuation of an earnout may change in two ways: on periodic remeasurement or on settlement. In either instance, an initial overestimate of the earnout value would result in the subsequent recognition of a gain, and an initial underestimate would result in the subsequent recognition of a loss. However,

although such treatment could provide an incentive for clients to report a higher earnout value through the potential to recognize a subsequent gain, the countermeasure is that any goodwill recorded as a result of the earnout's initial fair value measure will remain on the acquirer's books even if no earnout payments are made. As a result, such goodwill would be subject to annual impairment testing under FSP FAS 142, *Goodwill and Other Intangible Assets.*

## DISCLOSURE REQUIREMENTS

The disclosure requirements related to the initial measurement of contingent consideration are set forth in paragraph 68(g). For contingent consideration arrangements and indemnification assets, the requirements are the following:

1. The amount recognized as of the acquisition date.
2. A description of the arrangement and the basis for determining the amount of the payment.
3. An estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact.

As a result of the third item, clients may ask valuation specialists—in addition to estimating the fair value of the earnout—to provide some sensitivity analysis to support the new disclosure requirements.

## VALUATION OF EARNOUTS

Before covering specific valuation methodologies, it's useful to review appendix B of FSP FAS 141R. The following three excerpts discuss FASB's additional considerations in valuing contingent consideration:

> [A] contingent consideration arrangement is inherently part of the economic considerations in the negotiations between the buyer and seller.... The Boards observed that information used in those negotiations often will be helpful in estimating the fair value of the contingent obligation assumed by the acquirer. (paragraph B348)
>
> The Boards noted that most contingent consideration obligations are financial instruments and many are derivative instruments. Reporting entities that use such instruments extensively, auditors, and valuation professionals are familiar with the use of valuation techniques for estimating the fair values of financial instruments. The Boards concluded that acquirers should be able to use valuation techniques to develop estimates of the fair values of contingent consideration obligations that are sufficiently reliable for recognition. The Boards also observed that an effective estimate of zero for the acquisition-date fair value of contingent consideration, which often was the result of Statement 141 and IFRS 3, was unreliable. (paragraph B349)
>
> The Boards concluded that the negotiations between buyer and seller inherent in a contingent consideration arrangement in a business combination provide better evidence of its fair value than is likely to be available for most share-based payment arrangements with performance conditions. (paragraph B351)

These excerpts touch on important factors for the valuation specialist to consider in valuing earnouts, such as the following:

- An earnout is an option on future acquired company performance sold by the acquirer to the target seller.
- The conclusion that an earnout has a fair value of $0 may not be supportable, especially if approached as an option on future company performance.
- Rather than simply focusing on the reported transaction price (as was perhaps the prior practice under FSP FAS 141), a valuation specialist may need to focus more on the background of the negotiation process and the evolution of the purchase price, including the earnout.

The complexity of an earnout valuation will largely be determined by the complexity of its features. The primary methods to value an earnout will likely be either a discounted cash flow method, perhaps supplemented by a Monte Carlo simulation or an option-based methodology (Black Scholes, binomial, and so on). Our discussion focuses on earnouts with financial hurdles. Earnouts based on milestones (for example, FDA approval) will often require advanced valuation techniques, including real options analysis.

## DISCOUNTED CASH FLOW METHOD

A discounted cash flow analysis (DCF) using the selected most likely or, alternatively, the more theoretically correct, expected projected financial information (PFI), may initially appear to offer a straightforward method to value an earnout. The valuation specialist would simply compare the PFI to the appropriate earnout hurdle to determine whether an earnout was expected to be paid; the amount of the expected payment; and its timing. Assuming the earnout risk was determined to be similar to that of the overall PFI (that is, weighted average cost of capital for target), the valuation specialist would simply discount the earnout payments back to the measurement date to estimate the fair value of the earnout. (Note: The use of the acquisition internal rate of return to value the earnout is also possible, but is complicated by the circularity created because the earnout is an element of the purchase price.)

However, despite the appealing simplicity of this approach, its deficiencies would in most cases lead to an incorrect fair value estimate. For example, assume an earnout was based on $5 million EBITDA in year 1, but the selected PFI for year 1 EBITDA is only $4 million, then the single PFI approach would

conclude the fair value of the earnout is $0. This is incorrect, as illustrated by viewing an earnout as an option. Similar to "at the money" or "out of the money" stock option grants (which most valuation specialists, clients, and auditors are familiar with under FSP FAS 123R, *Share-Based Payment*), any earnout would theoretically have a positive, nonzero fair value as of the acquisition date. (Note: Materiality thresholds may mean that an auditor is comfortable with a client reporting a $0 value for an earnout in some transactions).

Because a DCF should theoretically use an *expected value* PFI (that is, probability weighted cash flows), typical scenarios would result in the PFI exceeding the earnout hurdle. If this was not true, the acquirer or target would not be likely to spend the time and money to create the earnout structure. The greater the uncertainty (or the more dispersed the probability distribution of the PFI), the greater the likelihood that the actual financial performance will result in an earnout payment.

Thus, the more theoretically correct methodology entails calculating the earnout payment under each PFI scenario, probability weighting each PFI scenario, and then summing the probability weighted earnout payments under each PFI scenario to calculate the fair value of the earnout. The single PFI or deterministic approach to valuing an earnout would undervalue the earnout in many, if not most, circumstances.

From a practical standpoint, it may be difficult to secure multiple scenarios from a client to perform such an analysis. However, assuming a client's deal team recognizes that earnouts are not "costless," they should have some expectations regarding the likelihood that the earnouts will be paid. Although earnout terms can vary widely in prior transactions, the client's historical payout experience may provide a data point to consider in assessing the likelihood of earnouts being paid under the subject transaction. A valuation specialist can discuss with a client such concepts as "worst case," "middle case," "best case," and so on, to develop PFI scenarios for further valuation analysis. The sum of the probability-weighted scenarios should get the analyst back to the expected PFI. Careful scrutiny of such PFI scenarios may reveal that if the distribution of PFI is asymmetrical in nature, an initial most likely or expected PFI will differ significantly from the calculated expected PFI. Obviously, this realization could have ramifications for FSP FAS 141R valuation of the entities' other assets and liabilities.

Recognizing the limits of deterministic DCF models and the practical difficulties in securing multiple PFI scenarios from a client, the valuation specialist should consider more commonly used—and perhaps more theoretically preferred—alternatives, including Monte Carlo simulation and option-based methodologies.

## MONTE CARLO SIMULATION

An analyst could supplement a DCF earnout valuation with a Monte Carlo simulation, which is most often performed using Excel add-in software such as Crystal Ball or @Risk. If the client is unable or unwilling to provide multiple scenarios to support a valuation, then the analyst can use probability distributions related to key discrete variables (revenues, market share, margins, and so on) to model the uncertainty related to the single PFI. Although Monte Carlo analysis requires assumptions in addition to those necessitated by a deterministic DCF, the former often provides helpful insights to the valuation specialist, client, and auditor.

For example, standard reports from simulation software can provide the expected value of the earnout; the range of potential earnout payments; the frequency at which an earnout is paid; and so on. Additional reports identify the variables with the greatest impact on earnout value, which the analyst could target for further consideration and discussion with the client. In the current environment, auditors and analysts tend to prefer additional documentation to support a financial reporting assignment, and such reports could be valuable.

## OPTION-BASED METHODOLOGIES

An option pricing model (Black Scholes, binomial, and the like) could be used to value an earnout. As mentioned previously, an earnout is, after all, an option of the future performance of the target company. As with any option model, the analyst will need to factor such variables as term to expiration, volatility, underlying asset, current value, strike value, and so on. The structure of the earnout could also influence the underlying asset (revenues, earnings, and so on) used within the option pricing model. With earnings-based options (EBITDA, most commonly), the analyst can model revenue by estimating an appropriate volatility of revenue growth rates, using most recent revenue as current price and future revenue as the strike price at the earnout measurement date. After solving the option value of the revenue, the analyst can then apply it to the appropriate expected EBITDA margin and earnout payout formula. However, if the EBITDA margin is highly sensitive to revenue levels, then a different structure would be preferable.

The valuation specialist may need to be creative in determining the volatility input. The more familiar equity valuation would likely provide a poor benchmark by which to select revenue volatility. Although analysts may default to subjective estimates of volatility, they can also use more sophisticated but relatively straightforward calculations to estimate volatility. For example, the analyst could calculate volatility based on the dollar-spread between best or worst case revenue scenarios and, using the confidence interval selected (for example, 95% confidence interval reflects 2 standard deviations around

the mean or expected value), estimate the standard deviation or volatility of revenue.[3] Similar to financial options, earnouts are more valuable the longer the term and the higher the uncertainty (as measured by volatility). Although it may seem counterintuitive, this last point is important for valuation specialists, clients, and auditors to remember.

Accurately measuring the value potential from more complex earnout structures will require analysts to create more complex option models, which many may have little to no experience building. Unfortunately, it seems unlikely that during negotiations, a client's deal team will consider a valuation specialist's capacity to perform fair value measurements on more complex earnout structures. Moreover, valuation specialists, clients, and auditors may have difficulty understanding and testing the accuracy or reasonableness of the values being derived for some earnouts. Accordingly, the valuation of earnouts under FSP FAS 141R will present new challenges during both the initial valuation by the valuation specialist as well as the subsequent review by the client, the auditor, and the audit firm's valuation specialists.

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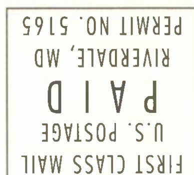
3 Enrique R. Arzac, *Valuation for Mergers, Buyouts, and Restructuring*, John Wiley & Sons, Inc. (NJ 2005), page 126.



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