

The Expert

SUMMER 2010

Impairment puts balance sheets to the test

Get real!

Using normalized earnings to clarify financial statements

How valuable is an outside expert in court?

Recent decision offers an answer

Computer fraud 101

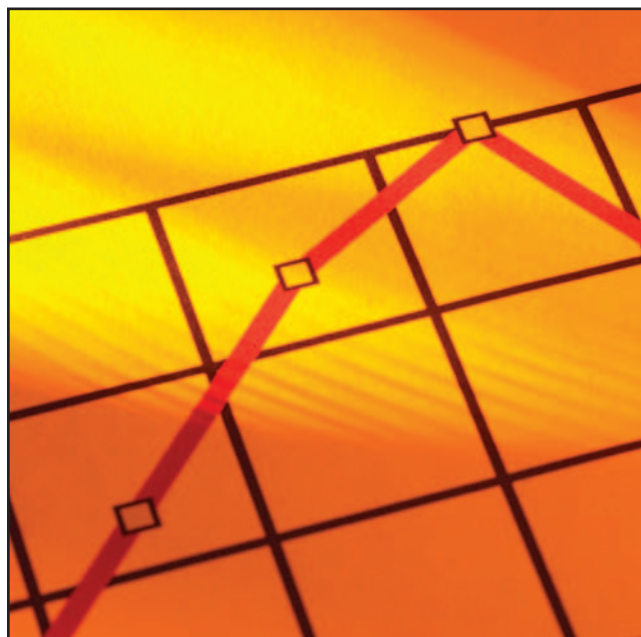


Impairment puts balance sheets to the test

Economic turmoil has taken its toll on asset values. One challenge that companies face is identifying assets acquired before the global financial crisis that have since declined in value. Once identified, management must quantify and report the amount of impairment.

But impairment testing is complicated and subjective. Some companies — especially private ones without internal valuation expertise — may be unaware of how to report impairment. Others may forestall impairment charges, which are early warning signs of financial distress, hoping that asset values will rebound.

When a company performance *does* fall short, lenders and investors may point the finger at management or auditors for failing to disclose asset impairment. Disgruntled stakeholders may allege professional negligence, accounting malpractice or even fraud. That's why, in today's turbulent marketplace, it's imperative that companies comply with impairment accounting rules and use outside valuation professionals to support their conclusions.



An overview of impairment

Financial Accounting Standards Board (FASB) Statement No. 142, *Goodwill and Other Intangible Assets*, requires companies that acquire goodwill and other indefinite-lived intangible assets to test those assets at least annually for impairment. (The old rules called for these assets to be amortized over 40 years.)

Impairment testing is a two-step process. First, you estimate the fair value of the company (or reporting unit if the company operates multiple lines or divisions). FASB Statement No. 157, *Fair Value Measurements*, defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

If the company's (or reporting unit's) fair value exceeds its carrying value, no impairment has incurred and the test is done. Carrying value refers to the amount reported on the balance sheet.

If carrying value exceeds fair value, more work is needed. To quantify the amount of impairment, an appraiser allocates fair value among all of the business's (or reporting unit's) tangible and identifiable intangible assets.

The remainder is the implied fair value of goodwill. The difference between the fair value and carrying value of goodwill is reported as an impairment loss on the company's income statement. Impairment losses can't be recovered in future periods, even if value recovers.

Rules for tangible assets

Under some conditions, FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, requires impairment testing on certain tangible assets, such as equipment, real estate or

Common impairment testing pitfalls

Economic instability has changed many valuation parameters, thereby complicating the impairment testing process. (See main article.) Common pitfalls include:

Failing to acknowledge declining discount rates. Appraisers typically use Treasury bond rates to quantify the risk-free rate, one component of the cost of equity. Although government bond returns have declined in recent years, other company- and industry-specific risk factors have risen. When novice valuers use lower discount rates in current impairment models, asset values are artificially inflated, which hides impairment.

Misapplying valuation metrics. Under the market and income approaches, value is a function of projected earnings and an observed pricing metric. Accurate valuations require apples-to-apples comparisons. Errors occur when appraisers apply, say, a price-to-earnings multiple to the company's projected revenues — or if they apply an after-tax discount rate to pretax cash flow.

Projecting unrealistic growth rates. Standard, consistent growth rates may not apply in a turbulent economy. Until conditions improve, appraisers may need to assume slower-than-normal growth rates over the next 12 to 36 months.

In some cases, multiple period discounting models may replace simpler capitalization models. Long-term growth rate — a key component of capitalization rates and terminal values — also should reflect current market conditions.

Failing to seek outside expertise. Impairment charges may be hard for management to swallow, and certain auditors may feel pressure to skew their tests to avoid reporting a loss. In fact, SEC auditor independence rules for public companies prevent auditors from providing valuations for certain clients if the results of the valuation are material to the auditor's financial statements.

A qualified outside appraiser should be able to avoid these pitfalls. In addition, he or she can review in-house impairment calculations, assist management in preparing relevant discount rates for each type of asset and help build cash flow models.

capital leases. Impairment occurs if the carrying amount of a long-lived asset isn't recoverable from its undiscounted cash flows.

As with goodwill, impairment equals the difference between the asset's carrying value and its fair value. Examples of events that trigger an impairment test for long-lived assets include a decrease in market share, an adverse regulatory change or a history of operating losses.

The purpose of it all

Impairment testing was designed to provide financial statement users with more meaningful information. Impairment charges also alert lenders, directors and investors to impending financial problems, such as asset obsolescence or overzealous acquisition strategies.

Bear in mind, however, that internally generated goodwill isn't reported on a company's balance sheet. Therefore, it's not subject to annual impairment testing.

A complex process

Estimating and reporting impairment is a complex process. And many in-house accounting personnel lack the requisite training to test for asset impairment — or to provide testing that can withstand outside scrutiny.

Although private businesses aren't subject to the SEC rules, all companies face greater scrutiny from stakeholders and a higher risk of litigation. So it's imperative to hire a credentialed appraiser to get impairment testing done right. ♦

Get real!

Using normalized earnings to clarify financial statements

You can't be too careful these days. In a time of great economic uncertainty, the estimated value of a given company can seemingly turn on a dime. To bring clarity to the situation, appraisers can calculate a company's "normalized earnings." This process allows them to determine, among other things, whether a struggling business is being mismanaged or whether a prosperous company is doing as well as it seems.

The method to the math

Valuators make adjustments after they study several critical areas. Most adjustments stem from the accounting method used in the financial statements. Under the cash basis method, for example, a company records revenue only as it's received and expenses only as they're paid. Thus, a company with high accounts receivable due could appear to have substandard revenue. And a business with significant debt may appear to be faring better than it is.

The income tax basis method, on the other hand, allows companies to defer some revenue, accelerate expenses (such as depreciation) and ignore other expenses (such as vacation pay). Valuators often find it necessary to convert earnings calculations using this method to an accrual basis, recording income and expenses in the period in which they were generated.

Under the cash basis method, a business with significant debt may appear to be faring better than it is.

Experts also adjust for depreciation and amortization. Fixed and intangible assets are depreciated based on their estimated useful lives and the method of allocating costs over those lives. But



the useful lives and methods chosen may bear little resemblance to the actual economic lives and related reduced value of assets.

A company might, for example, routinely depreciate equipment over five years, but use some of that equipment for 10 years. The financial statements must be adjusted accordingly. Adjustments are also required when companies elect Section 179 treatment for equipment purchases under the Internal Revenue Code.

Benefits and transactions

A variety of other adjustments can, depending on the company, be significant or relatively minor in the final calculation.

Take compensation and benefits, for example. Some businesses hide costs in their compensation and benefits — particularly those for owners. Salary, wages and bonuses may not represent ordinary and necessary business expenses or prove reasonable relative to the work performed.

When this is the case, experts adjust numbers to reflect the value of the actual services rendered. They also scrutinize benefits — including retirement plans, club memberships, auto expenses, insurance, and travel and entertainment — for reasonableness and necessity.

Another key area that appraisers look at is related-party transactions. Business transactions with parties related to a business's owners must be conducted at "arm's length." That is, if the business pays above- or below-market rental rates or prices for goods or services from related parties, experts make adjustments so that the goods and services represent fair market value. Sweetheart deals for favored customers also call for adjustments.

Little things count, too

Appraisers don't ignore the "little" things that show up in financial statements, either. Inventory, for instance, can make a difference — even in companies for which inventory isn't a huge focus. The last-in, first-out (LIFO) method of accounting for inventory can understate inventory and deflate earnings. Valuators generally convert inventory to the first-in, first-out (FIFO) basis for a more accurate balance sheet and cost of sales figure.

Repairs and maintenance costs factor in as well. Valuators review these expenses to determine whether capitalization or expensing is the more appropriate treatment.

And then there are the one-time entries. Recording income or expenses that are unlikely to recur can distort earnings. Valuators typically adjust for entries associated with developments that arise in the ordinary course of business, including litigation, government contracts or "acts of God."

A number of circumstances

A normalized earnings calculation can be valuable in a number of circumstances. These include divorce proceedings, ownership disputes, mergers or acquisitions, and shareholder litigation. The next time you need a more accurate picture of a company's earnings, ask a qualified appraiser to crunch the numbers for you. ♦

How valuable is an outside expert in court?

Recent decision offers an answer

Many people believe that an outside damages expert can lend credibility and objectivity to a legal argument. But, every so often, this belief is put to the test. Such was the case in *ICE Corporation v. Hamilton Sundstrand Corporation*.

Fighting over de-icing

ICE Corporation filed suit against two companies, Ratier-Figeac S.A.S. and Hamilton Sundstrand Corp., related to its airplane de-icing technology. In 2008, the jury found Ratier liable for breach of good faith and fair dealing as well as misappropriation of three trade secrets under the Kansas Uniform Trade Secrets Act (KUTSA). The jury awarded ICE \$153,708 on the breach of contract

claim and \$4,795,300 on the misappropriation of trade secrets claim.

Hamilton was also found liable for unjust enrichment and misappropriation of trade secrets; the jury awarded \$35,825 on the unjust enrichment claim, but the plaintiff's jury instructions inadvertently omitted a special interrogatory to quantify the amount of compensatory damages Hamilton owed on the misappropriation of trade secrets claim.

The omission was accepted as an honest mistake and a brief bench trial was held in 2009 to determine whether Hamilton was liable for compensatory damages. Hamilton contended that the plaintiff couldn't recover twice for the same wrong.

The defendant also argued that the damages expert provided insufficient evidence to support its lost profits calculation. Specifically, Hamilton found flaws in the expert’s production, cost, pricing, unit sales and profitability assumptions.

The court’s findings

The court opinion states, “Absolute certainty in proving lost future profits is not required.” Instead, the court must be guided by “some rational standard.” In other words, damage estimates should be based on judgment, not guesswork.

The court went on to review the evidence supporting each key assumption in the ICE expert’s analysis. It found that the expert’s assumptions were well supported by the evidence and testimony of several independent witnesses. Furthermore, the court ruled that many assumptions were conservative — possibly *understating* damages.

For example, the expert used lower costing data from 2006 even though the contract was negotiated in 2005. He also used pricing negotiated by a competitor despite the fact that it was lower than ICE’s quotes for similar technology. Additionally, the units of production didn’t include possible sales to China, the Russian states or the United States, though those were viable markets for airplane de-icing technology.

It’s also noteworthy that the expert provided no opinion about the value of the trade secrets themselves. Instead, he simply estimated the value of the plaintiff’s lost sales from the misappropriated trade secrets. Because of his conservative approach, the court gave “great weight” to the expert’s opinion and awarded the plaintiff the full amount of compensatory damages. The court did, however, recognize that any award against Hamilton must be “joint and several,” as a plaintiff may not recover twice for the same wrong.

Lessons learned

No specific professional designation qualifies a financial professional to calculate lost profits



or economic damages. But the ideal candidate understands business appraisal, corporate finance, accounting, marketing and tax issues.

Once an expert has been selected, courts tend to value objectivity and reasonableness. Experts who advocate on behalf of their client’s financial interests or who make aggressive assumptions about prospective earnings may be perceived as “hired guns.” In *ICE Corp.*, the court counter-balanced some speculative assumptions with the expert’s “conservative” approach.

Expert opinions also should be supported by objective third-party evidence, such as fact witness testimony, historic profitability, industry trends and competitor pricing.

Either way

Ultimately, expert witnesses don’t just benefit plaintiffs. They’re equally important for defendants. Without a competent opposing expert to point out flaws or alternate assumptions, courts have carte blanche authority to accept either side’s expert opinion in its entirety. ♦

Computer fraud 101

As digital data has become indispensable in almost every industry, the incidence of computer fraud has climbed accordingly. Although the schemes can prove difficult to detect, you can help clients minimize their losses by understanding the typical methods of computer fraud and calling in qualified experts at the first sign of trouble.

3 types of manipulation

Computer manipulation schemes target intangible assets represented in a digital format, including money-on-deposit, employee timecards and invoices. Experts recognize three types of computer manipulation:

1. Input manipulation. This is widely regarded as the most common type of computer fraud, as well as the easiest to commit and hardest to detect. Anyone with access to data entry functions at the input stage can manipulate the data to, for example, add to overtime hours or credit returned purchases at a store when items haven't, in fact, been returned.

2. Output manipulation. These schemes focus on a computer system's output. An ATM, for instance, might be manipulated to dispense more money than is requested.

Other output manipulation schemes make use of automatically repeated computer processes. A scheme could, for example, remove tiny amounts of cash from each financial transaction conducted and then divert it to another account, where the small amounts eventually pile up into substantial amounts.

3. Program manipulation. Here a fraudster changes existing programs or introduces new

programs to perform unauthorized functions. One example: so-called Trojan Horses, which hackers can insert in existing programs and use to conduct various operations, such as sending out mass e-mails. Program manipulation often goes undiscovered and can, at least, bring bad PR on afflicted companies.

Forgery and unauthorized access

The prevalence of advanced computer technology makes it possible for fraudsters to commit fraud in two other ways.

A perpetrator can, for instance, alter data in otherwise genuine digital documents — in other words, commit forgery. The perpetrator could also use computer technology to produce high-resolution copies of actual or forged documents.

Another relatively common scheme is unauthorized access, which isn't as straightforward as it may seem. Where at one time unauthorized access drew to mind images of

someone slipping behind the desk of an employee who left their computer on, such physical access is no longer necessary or typical.

Instead, perpetrators gain access remotely by finding holes in the security system or stealing passwords. The result can range from mere snooping to systemic sabotage.

An evolving threat

Computer fraud is constantly evolving to take advantage of ongoing technological advances. Don't take chances — if you suspect your client has been victimized, bring in a qualified forensic specialist to conduct a comprehensive fraud investigation. ♦

