Cohen & Co

Ethics in Valuation

PRESENTED BY:

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Welcome & Introductions

Peggy McCaffrey, CPA
Moderator

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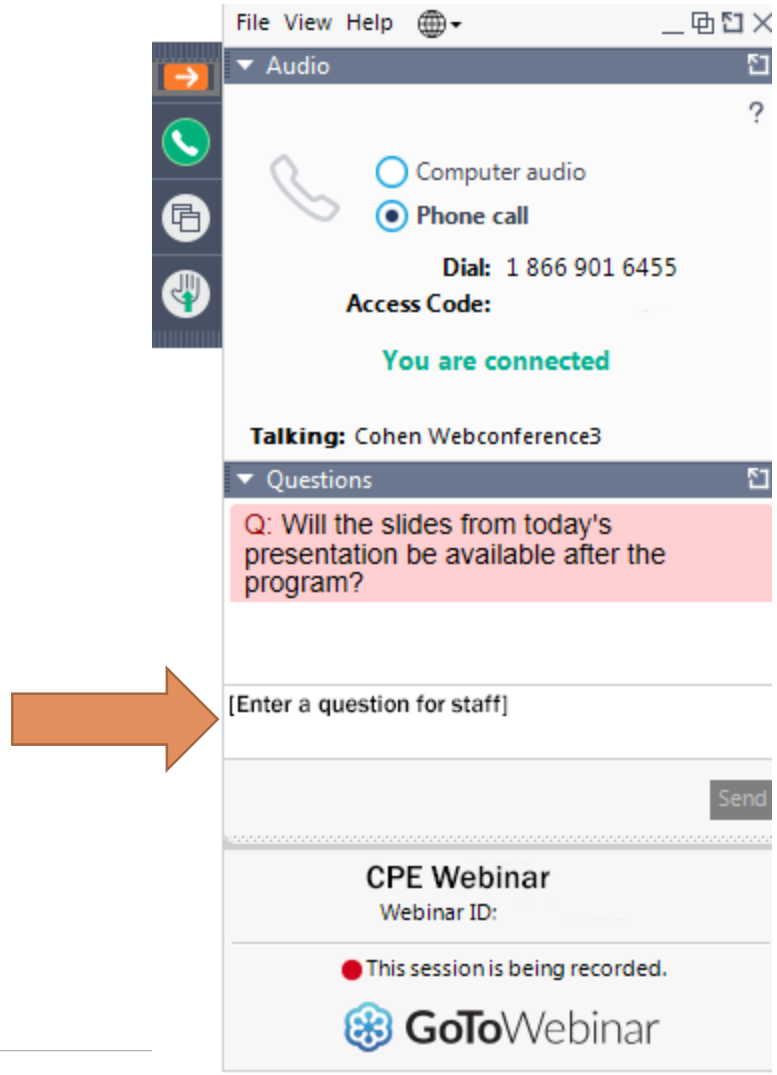
CPE Credit Guidelines

- To receive CPE you must:
  - Be logged in for at least 50 minutes during the active presentation
  - Answer at least 3 of the 4 polling questions

A copy of the slides will be available following the presentation

Questions During the Webinar

- If you have questions during the webinar:
  - Use the “Questions” feature to “Enter a question for staff” then click send
  - We will address during the program if there is time or will follow up after the program



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Overview

- Review professional valuation standards and recognize instances where ethical dilemmas arise and how to respond to them properly
  - Professional Standards
  - Ethical Dilemmas
    - Report Writing and Assumptions
    - Securities Valuation
    - Hard to Value Items – “Tax Planning”

Learning Objectives

By the end of this course a participant should be able to:

- Learn about professional valuation standards and the impact they have on what a valuation professional must do in a sound engagement/analysis
- Gain knowledge on how to recognize situations when ethical dilemmas exist
- Understand how to react to ethical dilemmas professionally

Professional Standards

Valuation professional organizations:

- American Society of Appraisers (ASA)
- American Institute of CPAs (AICPA)
- National Association of Certified Valuation Analysts
- CFA Institute
- Royal Institute of Chartered Surveyors

Professional Standards

- Engagement letter should make specific reference to the type of engagement
- Virtually any engagement, even simple general valuation consulting services, require adherence to certain professional standards
- All engagements require adherence to ethical standards

VS100 - Introduction

- Statement on Standards for Valuation Services (VS100)
- Relates to the valuation of a business, business interest, security, or intangible asset
- VS100 took effect in 2008 with the intent to provide AICPA members guidelines for developing estimates of value and reporting the results
- To improve consistency and quality of practice among members who perform engagement that estimate values
- Applicable sections for both valuation engagements and calculation engagements

VS100 - Professional Competence

- Member shall "undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence"
  - A valuation analyst should possess a level of knowledge of valuation principles and theory and
  - A level of skill in the application of such principles that will enable him or her to:
    - identify, gather, and analyze data,
    - consider and apply appropriate valuation approaches and methods, and
    - use professional judgment in developing the estimate of value.

VS100 - Professional Competence

- In determining whether he or she can reasonably expect to complete the valuation engagement with professional competence, the valuation analyst should consider, at a minimum, the following:
  - Subject entity and its industry
  - Subject interest
  - Valuation date
  - Scope of the valuation engagement
  - Government regulations or other professional standards that apply to the subject interest or to the valuation engagement

VS100 - Conclusion of Value

- In arriving at a conclusion of value, the valuation analyst should:
  - Correlate and reconcile the results obtained under the different approaches and methods used (i.e., income, market, cost)
  - Assess the reliability of the results under the different approaches and methods using the information gathered during the valuation engagement
  - Determine whether the conclusion of value should reflect the results of one valuation approach and method, or a combination of the results of more than one valuation approach and method

VS100 - Subsequent Events

- The valuation date is the specific date at which the valuation analyst estimates the value
- Generally, the valuation analyst should consider only circumstances existing at the valuation date and events occurring up to the valuation date
- Subsequent events are indicative of conditions not known or knowable at the valuation date

Polling Question #1

Uniform Standards of Professional Appraisal Practice

- Uniform Standards of Professional Appraisal Practice (USPAP)
  - Formed in 1986 by nine leading professional appraisal organizations including the ASA

- USPAP Ethics Rule
  - To promote and preserve the public trust inherent in appraisal practice by observing the highest standards of professional ethics. There are three sections:
    - Conduct
    - Management
    - Confidentiality

Uniform Standards of Professional Appraisal Practice

- Conduct
  - No Bias / Advocacy
  - No Predetermined Results
  - Cannot mislead results or commit fraud
- Management
  - Payment of undisclosed $$ in connection with the procurement of an assignment is unethical
  - No contingent compensation based upon an appraisal result
  - No false advertising

Uniform Standards of Professional Appraisal Practice

- Confidentiality
  - Protect client confidentiality
  - Act in good faith with respect to the usage of confidential information
  - Disclosure of information can only be to client or authorized representatives of the client

Other Professional Standards

- American Society of Appraisers
  - Principles of Appraisal Practice and Code of Ethics
  - Section 4: Appraiser's Obligation to His/Her Client - The appraiser's **primary** obligation to his/her client is to reach complete, accurate, and credible conclusions and numerical results **regardless** of the client's wishes or instructions in this regard. **The relationship between client and appraiser is not one of principal and agent.**

- AICPA Code of Professional Conduct

Polling Question #2

Ethical Dilemmas in Everyday Valuation Practice

- Report writing and assumptions
- Security Valuation Issues
- Hard to Value Items – Tax Manipulation

Valuation Report Writing

What not to do:

- Use subjective phrases such as "I believe" or "I feel" or "based on my experience" (Note there are exceptions when these phrases may be applicable)
  - These phrases often point toward a lack of supporting data and are used to justify outcomes that the facts do not support
- Fudge data or report sections without connecting the information to the valuation at hand
  - Cut and paste without checking, analyzing, and linking to current analysis appropriately
- Rounding - why are you rounding?
  - Be consistent. Rounding may be used to gear results towards a perceived outcome without a reasonable explanation
- Omitting relevant data that does not support your conclusions
  - Include the contradictory data and explain reasons it is not applicable

Valuation Report Writing

What not to do: (continued)

- Rely on outdated economic or financial data if more recent data is available
  - If management sends updated numbers, make sure analysis is reflective
- Include data, statistics, information or media without providing appropriate sourcing
  - Make it easy for your audience to validate your work while also avoiding any legal issues
- Use draft/final titles carelessly and keep draft versions of reports after final report has been issued to client
  - Be very clear if working report is draft making sure to not include any final signatures on draft copies

Security Valuation Issues

- Why an ethical issue:
  - Valuations drive AUM, which may drive management fees, carried interests, etc.
  - As auditor, we need to focus on not only security-by-security valuation, but also make sure that the total grouping is not unreasonably overstated

Polling Question #3

Security Valuation Issues

› What companies do to mitigate risk :

- Establish proper valuation standards/policies
- Engage valuation professionals when deemed necessary
- Contemporaneous Valuations - Perform valuations on frequent intervals or on a basis contemporaneous with significant events
- Assumption Validation - Validate the appropriateness of assumptions and estimates underlying the valuation
- The assumptions must be supportable and consistent with the characteristics of the security as of the valuation date to be deemed reasonable

Hard to Value Items - “Tax Planning”

DE Chancery Court
Fox, et al
v.
CDX Holdings, Inc.
CA No. 8031-VCL

Hard to Value Items - “Tax Planning”

- Relevant Parties
  - Sellers/Company Management
    - David Halbert – Caris Life Sciences Founder
    - Gerald Martino – EVP, CFO, COO of Caris
  - Kurt Fox – Plaintiff – Option Holder
  - Buyer - Miraca Holdings
  - Professionals
    - Grant Thornton LLP – Preparer of second opinion, as well as previous valuation work for the Company
    - PricewaterhouseCoopers – the Company’s tax advisor

Hard to Value Items - “Tax Planning”

› CFO Instructions to Valuation Specialists

- “ Guys, a real point of issue for the buyer is getting comfortable with the tax liability at closing. Can you guys prepare something in draft based on a $40 million or so valuation on SpinCo and the financial information on results for 2011 that I sent this morning? Thanks!!!!”

- Martino gave explicit instruction to PwC to prepare a valuation solely for the purpose of achieving a zero tax liability for Miraca.

Hard to Value Items - “Tax Planning”

› Case Background

- Caris Life Sciences, Inc. through its subsidiaries operated three business units:
  I. Caris Diagnostics –Steadily profitable unit bought by Caris in 2005
  II. TargetNow – Not profitable but generating revenue, purchased in 2008
  III. Carisome – Also purchased in 2008, not generating profit or revenue

- In 2011, Caris decided to sell Caris Diagnostics for the purposes of generating a return for shareholders and securing financing for TargetNow and Carisome.

- Miraca agreed to pay $725 million for the diagnostics business unit.

Hard to Value Items - “Tax Planning”

› Case Background (continued)

- In order to minimize taxes, the Transaction utilized a spin/merge structure
- Halbert maintained a 70.4% fully diluted equity share in the spun-off entity (“SpinCo”)
- JH Whitney VI retained a 26.7% stake in SpinCo
- Much of the remaining 2.9% of the fully diluted equity share took the form of stock options owned by employees of the Company. These options were cancelled in connection with the merger.
- Under the terms of the Company’s 2007 Stock Incentive Plan, in the event of a merger, each option holder was entitled to receive the amount by which the Fair Market Value exceeded the exercise price.

Hard to Value Items - “Tax Planning”

› Case Background (continued)

- One issue regarding the spin/merge structure of the Transaction was the impending taxable gain.
  - Under Section 355(e) of the Internal Revenue Code, Caris Diagnostics (aka “RemainCo”), the entity being merged with Miraca, would recognize taxable gain from the Spinoff as if it had sold TargetNow and Carisome to Caris’s stockholders for the fair market value of those businesses on the date of the Spinoff.
- FMV of SpinCo > its tax basis, RemainCo would owe tax on the difference.
- FMV < basis, the Spinoff would result in zero corporate-level tax.
- In September 2011, PwC prepared a tax transfer valuation for SpinCo. That analysis concluded an aggregate value of $62 million of certain IP Assets.

Hard to Value Items - “Tax Planning”

- Tax Considerations
  - Miraca’s bid letter identified the potential tax issues presented by the Spinoff and made clear that it did not want to be responsible for any taxable gain.
  - “Given the significant potential tax implications relating to the Separation, the parties agreeing on a reasonable valuation of the separate businesses, as well as finalizing a Separation Agreement, would be condition to the signing of the Merger Agreement.”
  - Martino then instructed PwC to prepare the tax transfer valuation for TargetNow and Carisome.

Hard to Value Items - "Tax Planning"

› Reduced Projections

Year	Revenue	August EBITDA	August EBITDA As % of Revenue	September EBITDA	September EBITDA As % of Revenue	% Reduction in EBITDA
2011	61,674,000	2,691,000	4.36%	(2,284,000)	-3.70%	184.88%
2012	84,507,000	9,344,000	11.06%	(422,000)	-0.50%	104.52%
2013	96,474,000	10,943,000	11.34%	2,428,000	2.52%	77.81%
2014	106,121,000	12,840,000	12.10%	4,241,000	4.00%	66.97%
2015	116,733,000	14,991,000	12.84%	6,006,000	5.15%	59.94%

Hard to Value Items - “Tax Planning”

- Miraca Insists On a Second Opinion
  - On September 22, Martino sent PwC’s $62 million valuation to Miraca’s tax advisor, Deloitte & Touche
  - Deloitte immediately raised questions regarding the valuation
  - An extensive back and forth between the two tax advisors ensued
  - With the signing of the final transaction agreement a week away, a compromise was struck wherein Caris would provide a side letter indemnifying Miraca for any tax liability and Caris would also obtain a second valuation opinion from Grant Thornton

Hard to Value Items - “Tax Planning”

- Impact on Options Holders
  - The Merger Agreement called for each non-dissenting share of RemainCo common stock to be converted into the right to receive $4.46 in cash.
  - Each in-the-money option was to be immediately converted into the right to receive the Option Payment. After which, all Company Options will no longer be outstanding.
  - The Option Plan called for different treatment of options in the event of a merger. The Plan stipulated in the event of a cancellation of options, the holders would receive the difference between the “Fair Market Value as defined by the Administrator and the exercise price for all shares of Common Stock subject to exercise.”
  - Fair Market Value was defined as “the value of the Common Stock as determined in good faith by the Administrator”

Hard to Value Items - “Tax Planning”

› Deal Announced

- On October 5th, the Board met telephonically and approved the deal. The timeline for the Transaction to formally close was approximately five to six weeks.
- Minutes of the meeting revealed the directors acknowledged the necessity to adjust the options; however, it would not have made sense to do so until receiving the Grant Thornton opinion.
- Later in the day on October 5th, Martino held an in-person meeting with PwC and Grant Thornton regarding the Valuation.
- A day later, Caris announced the Miraca Transaction.

Hard to Value Items - "Tax Planning"

- "the per share price of the Company is expected to be between **$5.04-$5.14**. This value is made up from the sale of the AP business to Miraca Holdings as well as the value of the Carisome and TargetNow businesses. *The valuation of the separated businesses was based upon a detailed examination of these businesses by two independent and nationally recognized business valuation firms*."

Hard to Value Items - “Tax Planning”

› Previous Analyses

- By the time of the Transaction, Grant Thornton had already provided Caris three formal stock option-related valuations and a valuation for purposes of Accounting Standard Codification 350 in 2011
- In the four previous valuations prepared by Grant Thornton, TargetNow and Carisome were concluded to equal approximately 35.6%, 36.7%, 39.3%, and 42.6% of the Company’s entire enterprise value. All of these valuations used a combination of valuation techniques.
- When hired for the purpose of valuing TargetNow and Carisome for the Spinoff, GT did not take positions consistent with its prior work

Hard to Value Items - "Tax Planning"

- Previous Analyses (continued)
  - GT's final opinion valued TargetNow at $37.1 million and Carisome at $17.6 million. Which accounts for just 7% of the combined enterprise value using the deal price of $750 million.
  - The ASC 350 report GT prepared earlier in 2011 had valued TargetNow at $104 million.
  - Halbert and Martino had told PwC that TargetNow was worth between $150 and $300 million. Carisome, according to Martino and Halbert, was worth at least as much as TargetNow.
  - According to the most recent stock option valuations, GT put the value of Carisome at $116 million, $147 million, and $169 million.
  - The court concluded that given the evidence, its was impossible to credit that Martino and Halbert actually believed in November 2011 that the value of TargetNow and Carisome was only $47.23 million and $17.79 million, respectively.

Hard to Value Items - “Tax Planning”

- Court Ruling
  - The Valuation Determination was not made in good faith: Martino wanted the valuations of SpinCo. suppressed for zero tax
  - The Valuation Determination was Arbitrary and Capricious: Once again, Martino set out with the aim of achieving a zero tax basis
  - With regards to the Option Holders, Martino attempted to use a Transfer Tax Valuation (PwC report), which did not actually equate the definition of fair market value under Revenue Ruling 59-60

Dealing with Ethical Issues in Practice

- Be cognizant of questionable areas of valuation and their effects
- Be wary of those with an agenda, which impacts value
- Do not predetermine outcomes
- Question unusual results
- When in doubt, raise the issue with colleagues or trusted advisor

Remember that the role of the valuation analyst is to be an advocate to our opinion, except in very limited circumstances.

Polling Question #4

Questions for our Presenter?

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Thank you.

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