

# VALUATION ISSUES™

Klaris, Thomson & Schroeder, Inc.

2003-1

## UNITED STATES TAX COURT CASE SUMMARY

T.C. MEMO 2003-66

Estate of Natalie M. Leichter v.  
Commissioner of Internal Revenue

Filed March 6, 2003

Judge Gerber

John A. Thomson, ASA, MAI

### IN THIS ISSUE...

- Auditor Independence.
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The single issue in this case was the value of a business known as Harlee International, Inc. ("Harlee") as of October 23, 1995. Harlee was a California corporation and operated as a wholesale distributor of futon frames. Harlee was founded in 1981 by Harvey Leichter. It began as a small importer and distributor of industrial fasteners imported from Asia. Harlee entered into the business of the wholesale distribution of waterbed frames and vinyl liners. After a decline in the waterbed market and approximately 1 ½ years before his death, Harvey Leichter became involved in the re-emerging futon market.

Through his overseas contacts, Harvey Leichter sought out Asian companies that could manufacture futon frames according to photographs and samples provided by Harlee. Harlee dealt directly with representatives who, in turn, were responsible for locating foreign companies and maintaining accounts with them. Harlee did not have contractual relationships with Asian

manufacturers. As of the decedent's date of death, Harlee was still in a period of transition from the waterbed to the futon market. Harlee's product line consisted of approximately 60 percent futon-related items and 40 percent waterbed-related items. Harlee was in competition with similar sized companies on a national level. Its customer base consisted of approximately 100 customers, which included retail stores, distributors and manufacturers.

**"The single issue in this case was the value of a business known as Harlee International, Inc. as of October 23, 1995."**

The Estate filed its return based on a value of Harlee's stock at \$2,091,750. This value was based on an appraisal by Lawrence F. Sherman, ASA, of Win Corporate Finance Inc. However, four years after his appraisal date he met again with the estate's representative (Mr. Steve Leichter and associated attorney) and was convinced by the Estate he had made an error in his first report, and it should really be \$900,000 lower (not a small error). We will comment on this flip flop by Mr Sherman later.

Because Mr. Steven Leichter was

disinherited by his mother, a conflict arose between Steven Leichter and Jeffrey Leichter (his brother). On March 20, 1996 the Superior Court appointed a probate referee to appraise and inventory the estate. This resulted in a value of the stock of \$2,261,713 which the two brothers agreed to and signed off on.

For purposes of the tax court trial, the Estate hired two additional "experts". One of the Estate's experts was a CPA, Mr. McCallum, and the other expert was a business broker named Mr. Garvin. Mr. McCallum opined on the value of Harlee stock to \$400,000 and Mr. Gavin opined it was \$863,000. In the interest of professional courtesy, we will not comment on these two alleged valuation experts (outside of the court's opinion).

KTS testified for the Internal Revenue Service in the case. This was, in our opinion, a straightforward business appraisal, on a control basis, with no discounts for lack of control or lack of marketability. The following comments from the court's opinion on each of the experts is educational.

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## Tax Court Memo 2003-66 (Cont.)

A. Mr. Sherman, ASA, the Estate's first expert (who did not testify at trial): The Estate argued that the Sherman appraisal (\$2,091,750) upon which the Estate relied in filing its 1995 estate tax return was erroneous. There were numerous typographical errors such as stating he had interviewed the decedent. However, the court stated while they (the Estate) might reflect that Mr. Sherman's appraisal needed proof reading, they do not show the value as erroneous.

B. Mr. Garvin was hired by the Estate for litigation purposes and opined that the value of Harlee was \$863,000 as of October 23, 1995. The court's comments were as follows:

(1) "Although Mr. Gavin seemed to have working knowledge of the market for this type of business, his appraisal approach and methodology are weak in several respects;"

(2) Mr. Garvin improperly concluded the \$1,254,408 note payable in his adjusted book approach, as a liability. However, this note had already been converted to equity;

(3) In arriving at book value, Mr. Gavin introduces negative goodwill of \$1,400,000 for which he provided no viable reason;

(4) He duplicated discounts taken for loss of key men for that reason among others, we question whether his report can be relied upon; and,

(5) He fails to explain why the hypothetical seller would choose not to liquidate when he concluded that the going concern value is less than the value of its assets.

C. Mr. McCallum, CPA, was hired by the Estate for litigation purposes and opined that the value of Harlee was \$400,000 as of December 31, 1995. The court comments as follows: "In reviewing Mr. McCallum's report, we find that his conclusions and analysis are brief and cursory in nature."

"We accord no weight to McCallum's report because of the lack of adequate explanation in support of his conclusions."

D. Mr. Thomson was hired by respondent for litigation purposes, and he opined that Harlee's value was \$2,150,000 as of October 23, 1995. The court comments as follows: "Mr. Thomson's methodology was within reasonable range and his conclusions were adequately supported by the facts in the record." The court went on to say they did find weakness in his approach

relative to the comparability of the guideline companies. However, KTS stated in their report and they testified

that the guideline companies, although the best available, were not as comparable as one would like. KTS testified that the more comparable the guideline companies the more weight given the approach and vice versa, thus we gave twice as much weight to the income approach over the guideline approach (only two approaches used).

In summary, you cannot merely hire someone who will produce a desirable

conclusion, if the conclusion is unreliable and unsupported. Although CPAs know something about valuation, that does not mean they are valuation experts merely because of their CPA designation. You must present a clear, concise, and supportable report if you are going to tax court, anything less is a disservice to your client. Also, we (appraisers) all make mistakes and typos occasionally, but it really does help if you have a second person review your work before presenting it as your work product. And, finally if you issue a report as your professional opinion, you better have a very solid reason (beyond client and attorney pressure) for flip flopping four years later and stating you may have overvalued the stock by 42 percent.

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*John A. Thomson, ASA, MAI is a Managing Director with KTS, Inc., in the Los Angeles Regional office, a Senior Member of the American Society of Appraisers (ASA) and a Member of the Appraisal Institute (MAI). (562) 597-0821 e-mail: jthomson@ktsvaluation.com*

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### Auditor Independence Part 2 of 2

By Alan M. Gochman, CPA

In our previous newsletter we presented Part 1 of our discussion on Auditor Independence. In this issue we will conclude our discussion.

The Securities and Exchange Commission (SEC) issued a final version of its auditor independence requirements, 33-7919, which became effective February 5, 2001. The rules imposed by the Securities and Exchange Commission are intended to eliminate any real or perceived conflicts of interest between accounting firms and their audit clients. These conflicts

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## Auditor Independence (Cont.)

also include business appraisals. The new requirement identifies when a conflict occurs in providing appraisal or valuation services and fairness opinions for an audit client. Additionally, the requirement defines the time frame allowed to adjust to the new set of rules. This section of the report reads as follows:

We are adopting a rule that, with some exceptions, provides that an accountant is not independent if the accountant provides appraisal or valuation services involving a fairness opinion.

Appraisal and valuation services include any process of valuing assets, both tangible and intangible, or liabilities. Fairness opinions are opinions that an accounting firm provides on the adequacy of consideration in a transaction. As explained more thoroughly in the Proposing Release, if an audit firm provides these services to an audit client, when it is time to audit the financial statements the accountant could well end up reviewing his or her own work, including key assumptions or variables suggested by his or her firm that underlie an entry in the financial statements. Where the service involves the preparation of projections of future results or future cash flows, the accountant may develop a mutuality of

interest with the audit client in attaining the forecasted results.

With respect to appraisal or valuation services or fairness opinions and internal audit services, however, we are providing for a longer transition because the new rule extends beyond current restrictions. Final rule 2-01(e)(1)(i) provides that an accountant's independence will not be impaired if the accountant continues for up to eighteen months to provide to an audit client these services, so long as

the services did not impair the accountant's independence under pre-existing independence requirements.

**"Overall, the new rules indicate that there is a question of independence if an accounting firm is auditing the books of a client and also provide business appraisals for the same client."**

Overall, the new rules indicate that there is a question of independence if an accounting firm is auditing the books of a client and also provide business appraisals for the same client.

Also, as shown above, appraisal or valuation services or fairness opinions were given a longer transition period of 18 months which technically meant that the rules went into effect on July 5, 2002 or 18 months after February 5, 2001.

However, the rules and legislation, as a fallout from the Enron Corp. disaster, does not end here. At the time of this writing, legislation had been passed in an attempt to address accounting and financial disclosure deceptions. The bill creates a new board under the authority of the Security and Exchange Commission to regulate auditors of publicly traded companies and punish errant accountants. It also

prohibits accounting firms from serving as an external auditor while doing certain types of consulting and other work for the same company.

In response to the 18 month deadline and pressure by government regulators to ensure auditor's independence from clients to whom they also provide business consulting services to, the face of consulting in the Big Five has started to change. Recently KPMG launched KPMG Consulting, a public company. KPMG Consulting changed it's name to solidify the separation from the auditing firm. Also Cap Gemini bought the consulting arm of Ernst & Young. Ernst & Young also has decided it will no longer sell IT services to companies it audits and will cease acting as both the internal and external auditors for a single client. In the wake of Enron, Deloitte and Touche Tohmatsu has reversed its position and said it would separate its consulting business. Previously, the company believed that it provided better service to its client base by maintaining its consulting business. PricewaterhouseCoopers launched an IPO for its consulting business to eliminate any potential problems between its auditing and consulting business.

In summary, the independence issue has created animosity between the accounting profession and the SEC. The question remains as to how "separate" the newly formed consulting firms will be from their original accounting firms. Only time will tell how compliance and enforcement will be handled.

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*Alan M. Gochman, CPA is a Valuation Consultant with KTS, Inc., in the Philadelphia regional office.  
(610) 446-8992  
e-mail: agochman@ktsvaluation.com*

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## **KTS CALENDAR**

### **RECENT AND UPCOMING SEMINARS AND SPEAKING ENGAGEMENTS**

- 12/11/02 Presentation—Grossberg Company LLP, Bethesda, MD.—"What's Going on in the World of Valuation."
- 1/22/03 Presentation—St. Louis Business Valuation Roundtable, St. Louis, MO.—"The Journey to Tax Court and its Alternatives."
- 1/23/03 Presentation—Spencer Fane Britt & Browne, LLP, St. Louis, MO.—"Advanced Valuation Topics."
- 1/24/03 Presentation—Thompson Coburn LLP, St. Louis, MO.—"Advanced Valuation Topics."
- 5/14/03 Presentation—St. Louis Business Valuation Roundtable, St. Louis, MO.—"Reviewing for the IRS."

### **KTS RECENT ENGAGEMENTS**

- \* Valuation of certain crypt and niche spaces in a unique mausoleum.
- \* Valuation of reasonable royalty rates in a patent infringement case.
- \* Valuation of lost profits in an anti-trust case.
- \* Fairness opinion of an asset purchase agreement for a fittings business.
- \* FASB 142 assignment for an educational software publisher.
- \* Valuation of intangible assets for the acquisition of large manufacturer and supplier of food products to the foodservice industry.



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### ***Valuation Issues*** ***2003-1***

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#### **Quarterly Quote:**

**"The game of life is not so much holding  
a good hand as playing a poor one well"**

**- H.T. Leslie**