Accounting Standards Codification Topic 450 and the Valuation of Contingent Liabilities

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This discussion presents (1) an overview of current and proposed guidance regarding the accounting for loss contingencies, (2) examples of common methods used by valuation analysts to estimate the value of contingent liabilities, and (3) guidance from three judicial decisions that have considered the valuation of contingent liabilities.

Introduction

Valuation analysts are frequently retained to estimate the value of an ownership interest in an entity that is exposed to a loss contingency. A loss contingency is defined as "an existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur."[1]

Examples of a loss contingency include the following:

1. Pending or threatened litigation
2. Environmental liabilities
3. Injury or damage caused by products sold

Entity financial statement accounts and footnotes may contain some of the necessary information required by valuation analysts to estimate the value of contingent liabilities. Accounting Standards Codification (ASC) 450 presents the existing guidance regarding the accounting for loss contingencies.

In an effort to continue the movement toward increased transparency in financial reporting, in July 2010, the Financial Accounting Standards Board (FASB) released a proposed Accounting Standards Update (ASU), *Disclosure of Certain Loss Contingencies*. The proposed ASU would require an increased disclosure regarding certain loss contingencies.

This discussion presents:

1. a summary of ASC 450, presenting existing professional guidance regarding the accounting for loss contingencies;
2. a summary of proposed ASU, *Disclosure for Certain Loss Contingencies*, presenting proposed amendments to existing guidance regarding accounting for loss contingencies;
3. common methods used by valuation analysts to estimate the value of contingent liabilities; and
4. insights from three judicial decisions that have considered the valuation of contingent liabilities.

Accounting Standards Codification Topic 450

Existing Guidance

ASC 450 requires companies to assess the degree of probability of an unfavorable outcome before reporting a loss contingency.

According to ASC 450, when a loss contingency exists, the likelihood that a future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote.

ASC 450 classifies the range of possible losses as *probable* (the future event or events are likely to occur), *reasonably possible* (the chance of the future event or events occurring is more than remote but less than likely), and *remote* (the chance of the future event or events occurring is slight).

According to ASC 450, an estimated loss from a loss contingency will be accrued by a charge to income if both of the following conditions are met:

1. Information available before the financial statements are issued or are available to be issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.
2. The amount of the loss can be reasonably estimated.

Therefore, ASC 450 requires the accrual of losses when:

1. they are probable,
2. they can be reasonably estimated, and
3. they relate to events or activities of the current or prior periods.

In accordance with ASC 450, entities normally disclose the nature of their loss contingencies. However, because of the complexities in reasonably estimating a specific loss figure, entities often do not provide estimates of their loss exposures.

Proposed Update

On July 20, 2010, the FASB issued a proposed ASU, *Disclosure of Certain Loss Contingencies*. The FASB's proposal is the culmination of an extended study following its 2008 proposal to amend the standards regarding loss contingencies.

The purpose of this ASU was to respond to financial statement users' concerns that disclosures about loss contingencies under the existing guidance do not provide adequate and timely information to assess the likelihood, timing, and magnitude of future cash outflows associated with loss contingencies.

The amendments in the proposed ASU would establish the following disclosure objective: an entity will disclose qualitative and quantitative information about loss contingencies to enable financial statement users to understand:

1. the nature of the loss contingencies,
2. the potential magnitude of the loss contingencies, and
3. the potential timing of the loss contingencies (if known).

Principles

According to the proposed ASU, to achieve this objective, an entity would consider the following principles in determining disclosures that are appropriate for its individual facts and circumstances for loss contingencies that meet the disclosure standard:

1. During early stages of a loss contingency's life cycle, an entity will disclose information that is available to enable users to understand the loss contingency's nature, potential magnitude, and potential timing (if known). Available information may be limited and, therefore, disclosure may be less extensive in the early stages of loss contingency.

   In subsequent reporting periods, disclosure will be more extensive as additional information about a potential unfavorable outcome becomes available.
2. An entity may aggregate disclosures about similar contingencies (for example, by class or type) so that disclosures are understandable and not too detailed. If an entity provides disclosures on an aggregated basis, it will disclose the basis for aggregation.

Disclosure Threshold

According to the proposed ASU, an entity will disclose information about a contingency if there is at least a reasonable possibility (that is, more than a remote possibility) that a loss may have been incurred regardless of whether the entity has accrued for such a loss (or any portion of that loss).

Disclosure is not required of a loss contingency involving an unasserted claim or assessment if there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless both of the following conditions are met:

1. It is considered probable that a claim will be asserted.
2. There is a reasonable possibility that the outcome will be unfavorable.

In addition, disclosure of asserted but remote loss contingencies may be necessary, due to their nature, potential magnitude, or potential timing (if known) to inform users about the entity's vulnerability to a potential severe impact (defined as a significant financially disruptive effect on the normal functioning of an entity).

Factors that an entity should consider in making this determination include any of the following:

1. The potential impact on the entity's operations
2. The cost to the entity for defending its contentions
3. The amount of effort and resources management may have to devote to resolve the contingency

According to the proposed ASU, when assessing the materiality of loss contingencies to determine whether disclosure is required, an entity shall not consider the possibility of recoveries from insurance or other indemnification arrangements.

Disclosure Requirements

The proposed ASU requires the following qualitative disclosures about loss contingencies that meet the disclosure threshold:

1. The entity must disclose qualitative information to enable users to understand the loss contingency's nature and risks.
2. During early stages of asserted litigation contingencies, the entity must disclose the contentions of the parties (for example, the basis for the claim and the amount of damages claimed by the plaintiff, and the basis for the entity's defense or a statement that the entity has not yet formulated its defense).

   In subsequent reporting periods, disclosure shall be more extensive as additional information about a potential unfavorable outcome becomes available.

   Furthermore, if known, an entity will disclose the anticipated timing of, or the next steps in, the resolution of individually material asserted litigation contingencies.
3. For individually material contingencies, disclosures should be detailed enough to enable financial statement users to obtain additional information from publicly available sources such as court records.
4. When the entity provides disclosure on an aggregated basis, the entity must provide the basis for aggregation and information that would enable financial statement users to understand the nature, potential magnitude, and potential timing (if known) of the loss.
5. For all contingencies that are at least reasonably possible (more than remote), an entity must make the following quantitative disclosures:
   a. Publicly available quantitative information—for example, in the case of litigation contingencies, the amount claimed by the plaintiff or the amount of damages indicated by the testimony of expert witnesses.
   b. If it can be estimated, the possible loss or range of loss and the amount accrued.
   c. If the possible loss or range of loss cannot be estimated, a statement that an estimate cannot be made and the reasons why.
   d. Other nonprivileged information that would be relevant to financial statement users to enable them to understand the potential magnitude of the possible loss.
   e. Information about possible recoveries from insurance and other sources only if, and to the extent that it has been provided to the plaintiff(s) in a litigation contingency, it is discoverable, or it relates to a recognized receivable for such recoveries.

      In addition, if the insurance company has denied, contested, or reserved its rights related to the entity's claim for recovery, an entity will disclose that fact.
6. For remote contingencies that meet the disclosure threshold:
   a. Publicly available quantitative information—for example, in the case of litigation contingencies, the amount claimed by the plaintiff or the amount of damages indicated by the testimony of expert witnesses.
   b. Other nonprivileged information that would be relevant to financial statement users to enable them to understand the potential magnitude of the possible loss.
   c. Information about possible recoveries from insurance and other sources only if, and to the extent that it has been provided to the plaintiff(s) in a litigation contingency, or it is discoverable. In addition, if the insurance company has denied, contested, or reserved its

rights related to the entity's claim for recovery, an entity shall disclose that fact.

Effective Dates of Proposed Guidance

For public entities, the new guidance would be effective for fiscal years ending after December 15, 2010, and interim and annual periods in subsequent fiscal years.

For nonpublic entities, the new guidance would be effective for the first annual period beginning after December 15, 2010, and for interim periods of fiscal years after the first annual period.

Contingent Liability Valuation Methods

Examples of methods that may be used by valuation analysts to estimate the impact of continent liabilities on the value conclusion include the following:

1. Directly estimate the value of the contingent liability and subtract this amount from the value indication from each valuation method.
2. Directly estimate the cost associated with buying an insurance policy that would cover any payment associated with the contingent liability and subtract this cost from the value indication from each valuation method.
3. Indirectly estimate the value of the contingent liability by applying a discount for lack of marketability that is greater than the discount for lack of marketability that would have been applied if the contingent liability did not exist.

The next section of this discussion presents an overview of three judicial decisions that have dealt with the valuation of contingent liabilities.

Valuation of Contingent Liabilities—Tax Court Precedents

Klauss v. Commissioner

Introduction

In *Klauss v. Commissioner*,[2] the U.S. Tax Court opined on the fair market value of a 40 percent interest in the common stock in Green Light Co., Inc. ("Green Light") owned by the Estate of Emily F. Klauss (the "Estate") as of February 1, 1993 (the "valuation date").

The important issues in *Klauss* included the following:

1. The appropriate methodology to estimate the value of a contingent liability (environmental and litigation claims)
2. The appropriateness of applying a small stock risk premium in the income approach method
3. The appropriateness of adjusting the multiple in the market approach method to reflect key differences between Green Light and the guideline companies.

The taxpayer valuation analyst estimated the fair market value of the Estate's interest in Green Light at $1,810,000 as of the valuation date. The Service valuation analyst estimated the fair market value of the interest in Green Light was $2,713,000.

The Tax Court found that the taxpayer analyst analysis was more persuasive, and opined that the fair market value of the 40 percent interest was $2,150,000.

The Facts of the Case

Green Light formulated and marketed (but did not manufacture) insecticides, weed killers, fungicides, plant foods, and other products for home and garden use.

The company sold its products to distributors, which sold them to retailers such as hardware stores and grocery stores. Green Light sold its products primarily in Texas, Oklahoma, Louisiana, New Mexico, Colorado, and Arizona.

In August 1991, the Texas Water Commission (later the Texas Natural Resources Conservation Commission (TNRCC)) told Green Light that soil at its San Antonio, Texas, facility was contaminated with chlordane and xylene.

The TNRCC ordered Green Light to submit a corrective action plan within 30 days. At the time of the trial, Green Light:

1. denied that its property was contaminated and
2. had not submitted a corrective action plan.

Green Light had $500,000 of products liability insurance in 1993, with a $50,000 deductible. It would have cost Green Light about $250,000 more to increase its 1992 product liability insurance coverage to $2 million, with a $1,000 deductible.

As of February 1, 1993, Green Light was a defendant in at least six product liability lawsuits resulting from the alleged misapplication of some of its products. The company faced potential liability of more than $100 million in these lawsuits.

Both the taxpayer valuation analyst and the Service valuation analyst used the income approach—capitalization of earnings method, and the market approach—guideline publicly traded company method, to estimate the fair market value of the stock. In addition, both valuation analysts used the same guideline companies.

The taxpayer valuation analyst and the Service valuation analyst primarily disagreed as to the following:

1. The appropriate methodology to estimate the contingent liability (environmental and litigation claims)
2. Whether to apply a small stock risk premium in the income approach method
3. The appropriateness of adjusting the multiple in the market approach method to reflect key differences between Green Light and the guideline companies.

The Tax Court Opinion

The first important issue to be decided by the Tax Court was the appropriate methodology to estimate the Green Light contingent liability.

The taxpayer valuation analyst directly estimated the contingent liability based on:

1. the cost to Green Light of increasing its products liability insurance coverage plus
2. the cost to Green Light to pay fines and remediation costs, such as excavation, transportation, and capping costs, and lab analysis, disposal, and environmental engineer and attorney fees to resolve the TNRCC enforcement action.

"The Tax Court found that the Service valuation analyst did not adequately consider the differences between Green Light and the guideline companies when estimating the appropriate Green Light multiples."

Based on these estimated costs, the taxpayer valuation analyst reduced his estimate of the Green Light marketable, noncontrolling value by $921,000.

In contrast, the Service valuation analyst indirectly estimated the contingent liability by applying a discount of 10 percent to the Green Light marketable, noncontrolling value before consideration of the contingent liability.

The Tax Court accepted the taxpayer valuation analyst approach to estimate the contingent liability because "we believe he more accurately accounted for the effects on the value of Green Light of the litigation and environmental claims."

The second key issue to be decided by the Tax Court was the appropriateness of applying a small stock risk premium in the income approach method.

The taxpayer valuation analyst included a small stock risk premium of 5.2 percent in estimating the discount rate in the income approach method. This small stock risk premium was based on historical data from Ibbotson Associates for the 1926–1992 period.

The Service valuation analyst did not include a small stock risk premium. The respondent attached an appendix to the opening brief showing that large capitalization stocks have outperformed small stocks since 1988.

In addition, the Service valuation analyst testified that it would be more appropriate to rely on Ibbotson data from 1978–1992, a more recent historical period.

The Tax Court concluded the taxpayer valuation analyst analysis to be more persuasive and accepted the use of a small stock risk premium of 5.2 percent.

The third key issue to be decided by the Tax Court was whether to adjust the multiple in the market approach method to reflect key differences between Green Light and the guideline companies.

The taxpayer valuation analyst adjusted the pricing multiples of the guideline companies to reflect differences in customer concentration, product mix, and geographic diversification.

The Tax Court found that the Service valuation analyst did not adequately consider the differences between Green Light and the guideline companies when estimating the appropriate Green Light pricing multiples.

Both valuation analysts agreed that the appropriate discount for lack of marketability was 30 percent.

The Tax Court applied a discount for lack of marketability of 30 percent to the adjusted marketable, noncontrolling value, resulting in a fair market value of $2,150,000 for the 40 percent ownership interest in Green Light common stock.

Desmond v. Commissioner

Introduction

In *Desmond v. Commissioner*,[3] the U.S. Tax Court opined on the fair market value of an 81.93 percent interest in the common stock of Deft, Inc. ("Deft") owned by the Estate of William J. Desmond (the "Estate") as of December 17, 1992 (the "valuation date").

The important issues in *Desmond* included the following:

1. The appropriate methodology to estimate the value of a contingent liability (environmental and litigation claims)
2. The appropriate factors to consider in estimating the discount for lack of marketability.

On the decedent's estate tax return, the petitioner reported that the fair market value of the decedent's interest in Deft was $6,160,576.

At the trial, the taxpayer valuation analyst determined the fair market value of the interest in Deft was $6,266,000. The Service valuation analyst determined the fair market value of the interest in Deft was $10,200,000.

The Tax Court found that the taxpayer analyst analysis was more persuasive, and opined that the fair market value of the 81.93 percent interest was $6,567,324.

The Facts of the Case

Deft was an S corporation that manufactured and sold industrial coatings for military and commercial aircraft, heavy duty trucks, and construction equipment. Deft also manufactured and sold finishes and wood stains. Deft, like other paint companies, was a hazardous waste producer.

From 1974 until 1991, Deft disposed of its hazardous waste at three disposal sites. As a result of its waste disposal, Deft faced large potential environmental liabilities.

The taxpayer valuation analyst used the asset-based approach—the adjusted net asset method, the income approach—the discounted cash flow method, and the market approach—the guideline publicly traded company method, to estimate the fair market value of the controlling ownership interest in Deft.

Under the adjusted net asset method, the taxpayer valuation analyst estimated a value of $12,070,000 on a marketable, controlling basis. In making this estimation, the analyst:

1. restated Deft's tangible assets from book value to fair market value,
2. calculated the value of Deft's intangible assets by capitalizing the excess of Deft's current sustainable earning power over the normal expected return of Deft's tangible assets, and
3. subtracted the company liabilities (excluding the potential environmental liabilities).

Under the discounted cash flow method, the taxpayer valuation analyst added (1) the present value of Deft's future cash flows for the 5 years following the valuation date and (2) the present value of the terminal value, to result in an indicated value of $8,109,000 on a marketable, controlling ownership interest basis.

Under the guideline publicly traded company method, the taxpayer valuation analyst selected eight publicly traded companies primarily engaged in the manufacture and sale of paint and coatings. These companies possessed similar business and financial characteristics to Deft. The valuation analyst focused on two companies that were most similar to Deft.

Next, the analyst discounted the average pricing multiples from these two companies by 30 percent to reflect differences in size between the guideline companies and Deft. In addition, the analyst added a 25 percent control premium to account for the fact that the multiples were based on noncontrolling interests in publicly traded companies, and the subject interest was a controlling interest. The indicated value from the guideline publicly traded company method was $10,196,000 on a marketable, controlling ownership interest basis.

Next, the taxpayer valuation analyst applied an equal weight to the indicated values from the valuation approach methods. This resulted in a marketable, controlling value of $10,196,000.

The taxpayer valuation analyst next applied a discount for lack of marketability of 25 percent to the marketable, controlling interest value. In selecting the discount for lack of marketability, the analyst considered, among other factors, the uncertainty regarding the potential company environmental liabilities.

The Service valuation analyst was instructed by the respondent to assume that the marketable, controlling interest value was $10,200,000. In addition, the Service analyst valuation report was limited to determining the appropriate discount for lack of marketability for the subject interest in Deft. The Service valuation analyst concluded that an appropriate discount for lack of marketability should be between 0 percent and 5 percent. As instructed by the respondent, the Service valuation analyst did not consider the potential environmental liabilities in determining the appropriate discount for lack of marketability.

The Tax Court Opinion

The Tax Court (1) rejected the taxpayer valuation analyst application of the asset-based approach as it was "improperly applied," but (2) accepted the taxpayer valuation analyst value conclusions based on the discounted cash flow method and the guideline publicly traded company method.

Next, the Tax Court applied equal weights to the indicated values from the discounted cash flow method and the guideline publicly traded company method. This calculation resulted in a marketable, controlling ownership interest value of $10,410,000.

In determining the appropriate amount of the discount, the Tax Court considered (1) the appropriate discount for lack of marketability and (2) the impact of the company potential environmental liabilities.

The Tax Court stated that "we believe that a hypothetical buyer of decedent's interest in Deft would consider these potential liabilities when negotiating a purchase price. We find that these potential liabilities must be taken into account in the valuing of decedent's interest."

During the trial, the respondent argued that applying a discount for the Deft potential environmental liabilities was not proper. This was because these liabilities were already included in the discounted cash flow method and the guideline publicly traded company method.

Specifically, the respondent argued that the beta used by the taxpayer valuation analyst to estimate the discount rate in the discounted cash flow method was based on guideline paint and finishing company data. The respondent argued that these companies had higher betas due to their potential environmental liabilities.

Applying a higher beta in the estimation of the cost of equity capital resulted in a higher discount rate and a lower indication of value from the discounted cash flow method.

The Tax Court was not persuaded by this argument. This was because the "respondent provided no evidence at trial that the betas of the eight comparable paint companies were higher than normal due to potential environmental liabilities faced by these companies."

In addition, the respondent argued that the valuation pricing multiples applied by the taxpayer valuation analyst in the guideline publicly traded company method already reflected the potential environmental problems faced by similar companies. Therefore, it was not appropriate to also consider these liabilities in determining the discount for lack of marketability.

The Service valuation expert testified that the guideline paint and finishing companies traded at lower pricing multiples as a result of the potential environmental liabilities associated with the industry. In addition, the petitioner did not provide any other explanation for the lower multiples.

Therefore, the Tax Court concluded that:

1. the pricing multiples applied in the guideline publicly traded company method took into account the potential environmental liabilities and
2. no additional valuation discount should be applied to the marketable, controlling interest value based on the guideline publicly traded company method for the potential environmental liabilities.

The Tax Court concluded that a 30 percent discount for lack of marketability is appropriate for the Deft stock. In addition, the Tax Court opined that 10 percent of the discount was attributable to the company's potential environmental liabilities.

Therefore, the Tax Court applied (1) a 30 percent discount for lack of marketability to the taxpayer valuation analyst indication of value from the discounted cash flow method and (2) a 20 percent discount for lack of marketability to the indication of value from the guideline publicly traded company method.

Based on these adjustments, the Tax Court opined that the fair market value of the subject ownership interest in Deft was $6,567,324.

Deputy v. Commissioner

Introduction

In *Deputy v. Commissioner*,[4] the U.S. Tax Court opined on the fair market value of a 19.99 percent interest in the common stock of Godfrey Conveyor Co., Inc. ("Godfrey") owned by the Estate of Helen A. Deputy (the "Estate") as of September 15, 1997 (the "valuation date").

The important issues in *Deputy* included:

1. the appropriate methodology to estimate the fair market value of the subject interest in Godfrey and
2. the appropriate methodology to estimate the value of a contingent liability (i.e., environmental claims).

On the original estate tax return, the Estate reported the fair market value of the Godfrey ownership interest at $2,246,500. After the respondent determined that the fair market value of the Godfrey ownership interest at $4,835,300, the Estate filed an amended estate tax return reflecting the fair market value of the Godfrey ownership interest at $1,941,000.

At the trial, the taxpayer valuation analyst determined the fair market value of the interest in Godfrey was $1,941,199. The Service valuation analyst determined the fair market value of the interest in Godfrey was $4,608,825.

The Tax Court opined that the fair market value of the 19.99 percent interest was $3,358,209.

The Facts of the Case

Godfrey was founded in Indiana in 1919. As of the valuation date, the company was the largest manufacturer of aluminum pontoon boats in the United States. In addition, in the years prior to the valuation date, the company had experienced consistent growth in sales and consistent profitability.

The taxpayer valuation analyst used the asset-based approach—and the adjusted net asset method—to estimate the fair market value of the noncontrolling ownership interest in Godfrey. The valuation analyst rejected the market approach. This is because he could not find comparable companies. In addition, the analyst did not rely on the income approach.

Under the adjusted net asset method, the taxpayer valuation analyst estimated a value of $17,341,379 on a marketable, controlling interest basis. In estimating this value, the analyst started with the book value of shareholders' equity, and subtracted $126,806 to account for the partial year. The valuation analyst explained the deduction as being attributable to an expectation that shareholders' equity would decrease by the end of the year.

Next, the taxpayer valuation analyst converted the book values of the company assets and liabilities to fair market value, and subtracted (1) $1,919,869 for environmental liabilities and (2) $165,566 for the built-in capital gain tax liability associated with the sale of the assets. This calculation resulted in a marketable, controlling interest value of $17,341,379 from the asset-based approach.

Next, the valuation analyst applied a 44 percent combined discount to reflect (1) the discount for lack of control and (2) the discount for lack of marketability. This resulted in a fair market value of the subject interest in Godfrey of $1,941,000.

The Service valuation analyst relied on the income approach—and the capitalization of cash flow method—to estimate the subject interest in Godfrey. The Service valuation analyst testified that the asset-based approach was not appropriate in this instance. This was because:

1. Godfrey was an established and successful operating company and
2. the use of the asset-based approach would "inappropriately imply that the company's value is limited to its tangible assets."

The Service valuation analyst concluded a marketable, noncontrolling interest value of $30,740,869 for Godfrey. Next, the analyst applied a 25 percent discount for lack of marketability. This calculation resulted in a fair market value for the subject interest in Godfrey of $4,608,825.

The Tax Court Opinion

The Tax Court rejected the taxpayer valuation analyst application of the asset-based approach. This was because the Tax Court "found his reasoning and/or basis for his conclusions in support of the adjustments (reductions) to be inadequate and without meaningful explanation."

The Tax Court relied on the Service valuation expert income approach with some adjustments to arrive at a marketable, noncontrolling value of $24,000,000 for Godfrey.

Next, the Tax Court applied a discount for lack of marketability of 30 percent. This calculation resulted in a fair market value for the subject interest in Godfrey of $3,358,209.

Summary and Conclusion

This discussion presented (1) a summary of ASC 450, (2) a summary of proposed ASU, *Disclosure for Certain Loss Contingencies*, (3) common methods used by valuation analysts to estimate the value of contingent liabilities, and (4) insights from three judicial decisions that have dealt with the valuation of contingent liabilities.

Insights from the *Klauss* decision include the following:

1. The Tax Court favored the approach used by the taxpayer valuation analyst to estimate the value of the contingent liability: (a) directly estimating the costs of increasing the entity's product liability insurance coverage and the cost to pay fines and remediation costs, and (b) subtracting these costs from the value indication from each valuation method.
2. The Tax Court rejected the approach used by the Service valuation analyst—indirectly estimating the value of the contingent liability by applying a valuation discount.
3. Based on the Klauss decision, the Tax Court generally favors a direct estimation of the contingent liability over an indirect estimation by applying a higher discount for lack of marketability, assuming the direct estimation of the contingent liability is accurately applied. According to the Tax Court, "we believe [the taxpayer valuation analyst] more accurately accounted for the effects of the litigation and environmental claims on the value of Green Light."

Insights from the *Desmond* decision include the following:

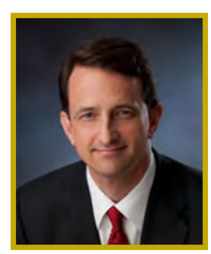
1. The Tax Court accepted the general approach used by the taxpayer valuation analyst to estimate the value of the contingent liability: indirectly estimating the value by applying a higher discount for lack of marketability than would have been applied if the contingent liability did not exist. Note, however, that as instructed by the respondent, the Service valuation analyst did not consider the potential environmental liabilities in determining the appropriate discount.
2. The Tax Court opined that in the application of the guideline publicly traded company method, the taxpayer valuation analyst double-counted the contingent liability. This is because the Tax Court found that the multiples of the guideline publicly traded companies already traded at lower multiples as a result of potential environmental liabilities associated with the industry. Therefore, when applying the indirect method to estimate the value of contingent liabilities, valuation analysts should ensure that the impact of the contingent liabilities have not already been included in arriving at the indicated value from the valuation methods before they apply a discount for lack of marketability.

The primary insight from the *Deputy* decision was that the direct approach to estimate the value of contingent liabilities will be rejected by the Tax Court if the valuation analyst does not provide adequate support for the value estimate.

The Tax Court rejected the taxpayer valuation analyst direct estimate of the contingent liability because it "found his reasoning and/or basis for his conclusions in support of the adjustments (reductions) to be inadequate and without meaningful explanation."

<u>Notes:</u>

1. Accounting Standards Codification Topic 450.
2. Estate of Emily F. Klauss and John G. Klauss v. Commissioner, T.C. Memo 2000-191, 79 T.C.M. (CCH) 2177 (2000).
3. Estate of William J. Desmond and Donn Kemble v. Commissioner, T.C. Memo 1999-76, 77 T.C.M. 1529 (CCH) (1999).
4. Estate of Helen A. Deputy v. Commissioner, T.C. Memo 2003-176 (2003).



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