

Valuation

Concepts



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Beg your pardon?

4 common valuation faux pas

The presence of an error, misstatement or erroneous deviation from customary valuation practice in an appraisal report could trigger (or worsen) an IRS inquiry or perhaps lead to an embarrassing courtroom mishap. Here are four common valuation faux pas that qualified appraisers avoid — and to which less-than-qualified ones often fall prey.

1. Outdated data

Business appraisals capture a company's value at a specific point in time. Therefore, they're contingent on the subject company's financial health, industry trends and general economic conditions on the valuation date.

To illustrate, consider the novice appraiser who values a travel company using comparable data from the last 20 years. With the advent of the Internet, and in light of the terrorist attacks of Sept. 11, 2001, the travel industry has changed significantly over the last two decades, leaving many older comparables irrelevant.

Similarly, in compliance with IRS Revenue Ruling 59-60, appraisers customarily review the subject company's financial performance over the last five years. If the business discontinued a product line or lost a key person in the last year, however, the company's historic data may not accurately indicate its future performance.



2. Overlooked adjustments

Appraisers frequently adjust the subject company's financial statements to reflect industry norms, arm's length transactions and unrecorded items. Appropriate adjustments vary from one valuation to the next but often include:

- Owner's compensation and "quasibusiness" expenses,
- Related-party expenses (such as rent or interest income from family member loans),
- Unusual or nonrecurring expenses (such as a change in accounting method or a gain from the sale of equipment),
- Income and expenses related to nonoperating assets (such as art, unexploited patents, real estate or surplus working capital), and
- Valuation discounts and premiums (such as discounts for lack of marketability and control, key person discounts and swing vote premiums).

Overlooking any of these adjustments (or other appropriate ones) can leave an appraisal report with critical flaws.

3. Incomplete valuation procedures

In adversarial situations or when resources are limited, appraisers sometimes omit certain routine procedures. For example, the monied spouse in a divorce case may refuse to permit the nonmonied spouse's appraiser to conduct a routine site visit or management interview.

Alternatively, some clients specifically ask for the company's value exclusively using a discounted cash flow analysis or an analysis of comparable private transactions.

Although it may suggest slipshod work, the omission of a step in the valuation process is not necessarily an error. The appraiser, however, must issue a "limited" report that clearly discloses the omission as a caveat to his or her value estimate.

4. Double dipping

Many valuation issues overlap. For example, marketability and control are interrelated and virtually impossible to separate completely.

Suppose an appraiser was estimating the value of a family-owned business engaged in numerous related-party transactions. When applying the income approach, he adjusted the company's cash flow for above-market related-party expenses and excess officers' compensation.

Although it may suggest slipshod work, the omission of a step in the valuation process is not necessarily an error.

Then, because the company treated family members favorably, he increased the company's cost of capital. Finally, he added a control premium to his preliminary value conclusion because he was valuing a large block of stock that possessed the requisite control to alter related-party expenses.

Clearly, in this hypothetical case, there is some degree of overlap between cash flow adjustments, factors used to build up the discount rate, and the control premium.

To the extent that the appraiser "double dipped" the effect of related-party transactions on the company's risk and return, his value estimate may be off the mark.

Avoiding the faux pas

A qualified, experienced appraiser is your first line of defense against these faux pas. Unfortunately, some unscrupulous or inexperienced experts exaggerate or misrepresent their qualifications to secure work. So be sure to verify appraisers' qualifications before retaining them.

And when you receive a valuation commissioned by another party, such as in litigation or a divorce, consider the appraisers' qualifications and look for these four valuation faux pas. Reviewing an appraisal report can be a daunting task, however. So, for a more complete assessment of a questionable report, consider hiring another expert to prepare an independent review or a rebuttal. <

C corporation focus

Challenges in estimating reasonable compensation

For C corporations, salaries, perks and related expenses reduce taxable income; dividends don't. Therefore, these companies can avoid double taxation by classifying payments to shareholder-employees as salary expense.

The danger: If the IRS successfully proves that an owner's compensation is unreasonable and some of it should be reclassified as dividends, it could collect twice — first from increased corporate-level taxable income, and, second, potentially from the shareholder personally in the form of additional dividend income. (The differential between federal tax rates on dividend income and federal tax rates on wages could mitigate the impact of such a change, however.)

Unreasonable compensation can create other headaches for C corporations as well, including IRS interest and penalties, adjustments to 401(k) and other qualified retirement plan contributions, changes to payroll tax withholding, and accumulated earnings tax issues.



The big picture

When evaluating whether compensation appears reasonable, the term "compensation" comprises a broad range of expenses beyond just salary, including payroll taxes, perks, bonuses and retirement plan contributions.

Some companies also provide executives with stock options, restricted share plans, performance-based awards and other forms of stock-based compensation. These can be especially difficult to evaluate objectively,

because they require appraisers to value speculative share-based instruments.

Benchmarking data

Appraisers frequently use salary surveys as the starting point for evaluating whether owners' compensation appears reasonable. Popular sources of executive salary benchmarking data include:

- America's Career Infonet (U.S. Department of Labor; www.acinet.org/acinet),
- Career Guide to Industries (U.S. Department of Labor; www.bls.gov),
- Career Journal (The Wall Street Journal; www.careerjournal.com), and
- Executive Compensation Assessor (Economic Research Institute; www.ერი.com).

Industry trade associations and executive headhunters can also serve as sources of comparable compensation data. Before relying on any external source, however, appraisers consider the data — and limitations — underlying the comparables.

A variety of factors

Rather than relying exclusively on, say, a national average from a salary survey, most appraisers adjust the average to reflect the assignment's distinctive characteristics. Critical factors include:

Owner-specific characteristics. Appraisers consider an executive's education level, knowledge of trade secrets or chemical formulas, key business relationships, and industry know-how. They also evaluate whether the owner guarantees corporate loans.

Duties and responsibilities. Appraisers generally look past job descriptions, which are often outdated and incomplete, and document exactly how the employee-owner contributes to the company. Many small business owners perform the functions of several individuals and work excessive hours.

Company-specific aspects. Large, complex or especially profitable companies usually pay executives more. Centralized management and reliance on key people (namely, the employee-owner) also justify higher compensation. Conversely, some small businesses boost compensation to attract and retain talented executives. Thus, an appraiser must look at the company's compensation policy and history of employee-owner payouts.

General economic conditions. Generally, companies can afford to pay higher salaries when the market is strong (and vice versa). Additionally, a tight labor market might call for salary increases to attract and retain key executives.



Independent investor test

Since the landmark ruling in *Exacto Spring Corporation v. Commissioner*, the Tax Court has favored an alternate approach to estimating reasonable compensation called the independent investor test. Rather than focusing on an owner's gross salary, this test looks at owners' compensation through the lens of a hypothetical investor.

The test is predicated on the assumption that investors expect a reasonable rate of return via dividends and capital appreciation. As long as shareholders receive a reasonable return, owners' compensation is presumed reasonable.

Unfortunately, the independent investor test is just as subjective as building up reasonable compensation using case-specific factors. It requires an appraiser to evaluate dividends in conjunction with capital appreciation.

Estimating capital appreciation requires an appraiser to quantify how much the company's value has increased since the shareholder purchased or created it. For private companies with limited arm's length transaction data, such calculations are complex and time-consuming.

The eyes of the beholder

Reasonableness lies in the eyes of the beholder — and the IRS may not see eye-to-eye with a subject company. Appraisers can help C corporations devise reasonable, defensible compensation deductions that satisfy the independent investor test and factor in the distinctive attributes of the corporation and its individual shareholders. ◇

Stock option valuation showdown

Black-Scholes vs. binomial lattice

Employee stock options (ESOs) have become a popular way for companies to attract and retain talented workers. Unfortunately, accounting for ESOs has become significantly more complicated in recent years. The generally accepted accounting principles (GAAP) regarding ESOs have been revised, and, as a result, employers typically must choose between the two most popular valuation techniques for ESOs — Black-Scholes and binomial lattice.

That was then ...

Until recently, companies had two options when recording ESOs: intrinsic value or fair value. Intrinsic value was the difference between the company's stock price and the option's exercise price, in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*.

To illustrate, assume a company's stock was selling for \$30 per share and an employee was granted an option to purchase shares for \$20 each. The option's intrinsic value would be \$10.

FASB guidance on fair value

Absent observable market prices or comparable instruments with similar terms and conditions, the Financial Accounting Standards Board (FASB) requires companies to consider the following inputs in their option pricing models:

- Exercise price of the employee stock option (ESO),
- Expected term of the ESO, taking into account both the option's contractual term and the effects of employees' expected exercise and postvesting employment termination behavior,
- Current price per share,
- Expected stock-price volatility or, for private companies with insufficient historical pricing data, the historical volatility of an appropriate industry sector index,
- Expected dividend yield, and
- Risk-free interest rate.

Few companies issue options that are “in the money” (that have an exercise price less than the current stock price) on the grant date. So, under the intrinsic method, ESOs typically generated no compensation expense until exercised.

In 1995, the Financial Accounting Standards Board (FASB) began applying the concept of fair value to ESOs. Statement No. 123, *Accounting for Stock-Based Compensation*, defines fair value as:

The amount at which an asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

Statement No. 123 matches compensation expense to the periods in which employees provide services (either the requisite service or a vesting period). It also increases additional paid-in capital (or a liability account, depending on the characteristic of the transaction) and causes complicated deferred tax consequences.

When given the choice, most companies selected intrinsic value. Not only was it more familiar and easier to calculate, but it also preserved profits by deferring expense recognition until when (and if) employees exercised their options.

... and this is now

Under Congressional pressure to reform stock option accounting procedures, FASB issued Statement No. 123(R), *Share-Based Payment*, in December 2004. This controversial new rule eliminates the intrinsic method, thereby forcing companies to estimate the fair value of ESOs and other forms of stock-based compensation — including restricted share plans, performance-based awards and share appreciation rights plans.

Statement No. 123(R) has created quite a stir in the accounting community. Its exposure draft received more than 13,000 comment letters. By comparison, most proposed FASB statements receive fewer than 100 responses. This revision is especially unpopular among private entities that lack the requisite financial

expertise and stock price data to estimate the fair value of their ESOs.

Statement No. 123(R) identifies two acceptable types of option-pricing models for estimating the fair values of ESOs: closed-form models, such as the Black-Scholes formula, and lattice models, such as binomial lattices.

The Black-Scholes formula

The Black-Scholes-Merton (or simply Black-Scholes) model is a Nobel Prize–winning formula based on calculus. It provides a defined equation and is, therefore, widely used — especially among entities that don't issue many ESOs. Because of its widespread acceptance, some argue that conformity to this model allows for greater comparability among entities that grant stock options.

The Black-Scholes model has its limits, however. It was developed to value European exchange-traded options and, therefore, lacks the flexibility to incorporate the nuances of ESOs. Namely, the Black-Scholes formula assumes that employees exercise options at the end of contractual terms and that expected volatility, expected dividends and risk-free interest rates are constant over the option's term.

To capture the effect of early exercise, FASB allows companies to substitute an option's expected term for its contractual term. But the use of the Black-Scholes model ignores other factors that make ESOs less valuable than exchange-traded options, such as vesting requirements, forfeiture, nontransferability, change-in-control provisions, employee suboptimal exercise behavior, dilution and blackout periods.

Binomial lattices

In contrast, proponents of binomial lattices contend that these models more accurately value ESOs because they can accommodate dynamic assumptions of expected volatility, dividends and option exercise patterns over the option's contractual term.

For example, an appraiser might assume that all (or a percentage of) employees will exercise their options if the stock price reaches a predetermined multiple of the exercise price or that volatility will decrease from, say, 40% to 30% over the option's term.

Because they can accommodate the traits that make ESOs less marketable than exchange-traded options, binomial lattices typically generate lower fair values and, accordingly, reduce the amount subtracted from profits for compensation expense.

The mathematics underlying a binomial lattice is simple algebra that can be demonstrated pictorially with the use of decision trees. These models assume that stock price follows a binomial distribution in which there are only two possible outcomes in each period — to increase or decrease by the expected volatility.

Once a binomial lattice model calculates probable stock price distributions over the option's life, it estimates the option's intrinsic value at each node (or probable outcome) in the decision tree. Whenever the option has intrinsic value and meets other criteria (such as early exercise assumptions and vesting requirements), the lattice assumes the employee will exercise the ESO.

Next, these expected intrinsic values are multiplied by their respective probabilities and discounted to their present values using the risk-free interest rate. The sum of these present values estimates the ESO's fair value.

By comparing the ESO's fair value to its "as-if-freely-traded" value (typically calculated using an unmodified binomial lattice or the Black-Scholes method), appraisers can impute a marketability discount. In turn, this comparison can serve as a reasonableness test for the fair value of ESOs.

The primary downside to lattice models is that they require significant technical expertise and computing power to handle the volume of reiterations, varying assumptions and contingencies.

Some appraisers create proprietary binomial lattice spreadsheets to value ESOs. Others purchase third-party software to handle the calculations. These programs can also be rerun under varying assumptions to ascertain which variables are the most sensitive inputs.

An important choice

FASB does not specify a preference for either model; rather, the appropriate technique depends on the unique characteristics of the ESO. Regardless of the model selected, all fair value estimates should be reasonable and supportable as determined by a qualified appraiser. ◇

Estate of Blount and a buy-sell agreement gone bad

Valuation issues are top priority when drafting a buy-sell agreement. The IRS may challenge gift and estate returns based solely on a company's buy-sell agreement, especially for family-owned or single-owner businesses.

The case of *Estate of Blount v. Commissioner* casts light on how shareholders can preserve the integrity of their buy-sell agreements in court.

Rebuilding a buy-sell

When he died in September 1997, George Blount owned 83.2% of Blount Construction Company (BCC). BCC's employee stock ownership plan (ESOP) owned the company's remaining shares.

After learning he had cancer, Blount unilaterally modified BCC's buy-sell agreement. The old agreement, which was used to buy out another shareholder in 1996, set BCC's price at book value. The new buy-sell agreement subjectively valued BCC at \$4 million. The IRS challenged Blount's estate tax return, based solely on the revised buy-sell agreement, contending that BCC was worth approximately \$10 million.

The Tax Court disregarded the value set forth in the revised buy-sell agreement and a \$750,000 ESOP repurchase liability. The court also included a company-owned life insurance policy on Blount worth approximately \$3.1 million. As a result, the court valued BCC at approximately \$9.9 million.

This ruling was upheld on appeal, except for the inclusion of the life insurance proceeds. The appellate court ruled that, even though the buy-sell agreement didn't provide appraisal evidence of the business's value for estate tax purposes, the agreement was enforceable under state law.

Accordingly, all of the \$3.1 million in insurance proceeds were offset by BCC's obligation to repurchase Blount's shares. The appeals court ultimately valued the business at roughly \$6.8 million (\$9.9 million – \$3.1 million).

Satisfying Section 2703

The Tax Court disregarded BCC's buy-sell agreement in determining value for estate tax purposes, in part, because it failed to satisfy the requirements of Internal Revenue Code (IRC) Section 2703(b). The general rule set forth in Sec. 2703(a) is that no weight shall be given to a buy-sell agreement in establishing the fair market value of a closely held business interest for estate tax purposes.

There are some exceptions to this general rule. Sec. 2703(b) provides a three-part test to determine whether a buy-sell agreement can be used as appraisal evidence in court:

1. It must be a bona fide business arrangement.
2. It must not be a device to transfer such property to the members of the decedent's family for less than a full and adequate consideration.
3. Its terms must be comparable to similar arrangements entered into by persons in an arms' length transaction.

Proving comparability is especially troublesome for taxpayers. Congress contemplated that business "comparables" that establish "the general practice of unrelated parties" would constitute the evidence satisfying this third test. In *Estate of Blount*, the company's buy-sell agreement fell short because the court ruled that parties were related and the buyout terms were not at arm's length.

Seeing into the future

This recent case represents an important IRS victory and could provide insight into future IRS attack strategies. Buy-sell agreements among related parties — and those that base value on preset lump sums, book value or industry "rules-of-thumb" — may raise a red flag.