Valuation Concepts

inside:

summer 2006

Taking stock of options

Independent appraisals help ensure Section 409A compliance

The American Jobs Creation Act of 2004 (AJCA) took aim at perceived corporate abuses involving executive compensation by adding Internal Revenue Code Section 409A, which prohibits accelerated payments of nonqualified deferred compensation, including stock options and stock appreciation rights (SARs).

Sec. 409A also imposes tough new restrictions on the timing of deferral elections and distributions and the ability to change the form or timing of distributions. The penalties for noncompliance are harsh: immediate taxation (plus a 20% excise tax and interest) of any benefits not subject to a "substantial risk of forfeiture." Generally, this means benefits contingent on performing substantial future services, achieving a certain level of earnings or some other condition.

To avoid these consequences, a company must establish that options and SARs were issued at fair market value (FMV). And for a privately held business, the best way to do this is through regular, independent appraisals of its stock.

Why appraisals matter

Equity-based compensation — such as stock options and SARs — almost always runs afoul of Sec. 409A's requirements because, by definition, the employee controls the timing of the benefits. But under proposed regulations issued last October, Sec. 409A doesn't apply to stock options or SARs that have: 1) an exercise price that can never be less than the stock's FMV on the grant date, and 2) no other feature for deferring compensation.

Qualifying incentive stock options (ISOs) are also exempt. Because ISOs are required to be issued at FMV, then, for all practical purposes, the valuation issues are the same for ISOs, nonqualified stock options (NQSOs) and SARs. To avoid being subject to Sec. 409A and ensure that options and SARs remain an effective tool for attracting and retaining executive talent, a company must ensure that they're issued at FMV.

Discounted NQSOs and SARs — that is, issued at less than FMV — are no longer a viable compensation tool.

Valuation options

The proposed regulations provide that a privately held company can determine FMV through the "reasonable application of a reasonable valuation method." Although reasonableness depends on the facts and circumstances, a reasonable valuation method should consider:

- The value of the company's tangible and intangible assets,
- The present value of future cash flows,
- Stock prices of comparable public companies or arm's-length sales prices of comparable private companies,
- Control premiums and discounts for lack of marketability, and
- The valuation method's use for other material purposes.

A valuation method is not reasonable if it: 1) fails to consider all material information available, 2) was performed more than 12 months before the grant date, or 3) fails to reflect significant events that took place after the valuation was performed, such as the resolution of material litigation or the issuance of a patent.

3 safe harbors

The proposed regs do, however, establish three safe harbors, or "presumptive" valuation methods:

1. An independent appraisal. A valuation by a qualified independent appraiser using traditional methodologies is presumed reasonable if it's performed within 12 months before the grant date (unless intervening events had a material impact).

2. The illiquid startup method. An appraisal of an illiquid startup corporation — that is, one that's been in business less than 10 years and has no publicly traded stock — is presumed reasonable if:

- It's evidenced by a written report and accounts for the previously mentioned reasonableness factors,
- It's performed by someone with significant knowledge and experience or training in performing similar valuations,
- The stock isn't subject to any put or call rights (except for certain repurchase or first refusal rights held by the company), and
- The company doesn't reasonably anticipate an initial public offering (IPO), sale or change in control within 12 months after the grant date.

3. The formula method. A valuation is presumed reasonable if it's based on a formula used in a buy-sell agreement or other nonlapse restriction, and the formula is used for all noncompensatory valuation purposes, such as regulatory filings, loan covenants and third-party sales. This safe harbor is of limited value to private companies.

A company is free to use any reasonable method to value stock options and SARs, but the presumptive methods offer a big advantage: To reject a valuation, the IRS must prove that the method or its application was "grossly unreasonable."

Most companies will likely use the independent appraisal or illiquid startup methods. Presumably, a company using the latter method can rely on a written valuation by an experienced financial officer or board member.

This approach may be cheaper and faster, but it's also riskier. The IRS is more likely to challenge a valuation conducted by an insider, and it may be difficult to refute a claim that the company anticipated an IPO or sale.

The best protection

Ultimately, an independent appraisal offers the best protection against Sec. 409A. Traditional valuation methodologies give the appraiser the flexibility to choose an approach that's appropriate for the subject company, and they're difficult for the IRS to attack.

To ensure that options and SARs are priced appropriately, appraisals should be conducted regularly so that they're close to the grant date and reflect any significant value-changing events.

Section 409A relief for existing options

Although Section 409A took effect Jan. 1, 2005, it applies to options granted earlier but earned and vested after the effective date. Recognizing the potential unfairness to companies that set option prices before Sec. 409A became law, the IRS offered some relief in Notice 2006-4.

Under it, options and stock appreciation rights granted before Jan. 1, 2005, are deemed to have been granted at fair market value (FMV) for Sec. 409A purposes if the company made a good faith attempt to set an FMV exercise price.

IRS regulations for gift and estate tax valuations

What you need to know

One common reason for obtaining a business appraisal is to ascertain gift and estate tax liability. And among the most important considerations in this area are the IRS regulations regarding gift and estate tax valuations, which are addressed in the Internal Revenue Code as *Submission of Appraisals in Lieu of Information Required under Paragraph 301.6501(f)(2)(iv)*.

Section 301.6501(f)(2)(iv) lists the requirements appraisers must abide by to ensure their clients qualify for the three-year audit statute of limitations, which is the time frame during which the IRS may audit the return. The three-year period begins once the return is correctly filed under what the IRS considers adequate disclosure. After the three years expire, the return can no longer be audited.

Appraiser qualifications

Under the IRS regulations, appraisers must have certain qualifications. They need to hold themselves out to the public as an appraiser or regularly perform valuations.

An appraiser should also be qualified to value the subject property, given his or her background, experience, education, membership and training, as detailed in the appraisal report. In addition, the appraiser cannot be the donor or donee of the property being valued or an employee of the donor or donee.

Report contents

The lion's share of Sec. 301.6501(f)(2)(iv), however, deals with the valuation report itself. The IRS will consider the report to have adequate disclosure only if it contains the following information:

Property specifications. The report must state the appraisal's date and purpose as well as the date of property transfer. It needs to also describe the property being valued and the appraisal processes, approaches and methodologies employed by the appraiser.

In addition, the report should explain the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analysis, opinions and conclusions.

A documentation description. This includes all of the financial information the appraiser used to arrive at an opinion of value. He or she must include enough detail to allow a third party to replicate the appraisal process and arrive at the same value estimate.

Procedural disclosures. The report needs to describe the valuation procedures employed and the reasoning set forth that supports the analysis performed, opinions stated and value estimated.

It should also offer a rationale for using the various methods and procedures in determining the property's fair market value that's the subject of the transfer. Last, the report must detail a specific basis for the valuation, such as comparable transactions or sales of interests that are comparable to the interest being transferred.

8 fundamental factors

In addition to meeting the Sec. 301.6501(f)(2)(iv) requirements, an appraiser needs to adhere to Revenue Ruling 59-60 when preparing a valuation for gift and estate tax purposes. In doing so, there are eight fundamental factors to consider:

1. The nature of the business and the history of the enterprise from its inception,
2. The economic outlook in general and the condition and outlook of the company's specific industry,

3. The book value of stock and the financial condition of the property being valued,
4. The earning capacity of the property being valued,
5. The dividend-paying capacity of the subject property,
6. Whether the enterprise has goodwill or other intangible value,
7. Sales of the stock and the size of the block of stock to be valued, and
8. The market price of stocks of corporations engaged in the same, or a similar, line of business and whose shares are actively traded in a free and open market, either on an exchange or over the counter.

Note that Sec. 301.6501(f)(2)(iv) does affect Revenue Ruling 59-60 — a fact that appraisers should take into account when conducting a valuation.

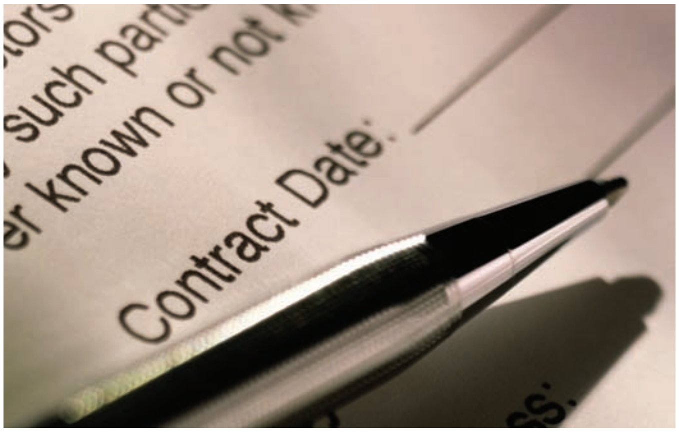
The government's eyes

The IRS requirements under Sec. 301.6501(f)(2)(iv) aren't all that dissimilar from what one would probably find in a full valuation report prepared by a qualified appraiser anyway.

Nonetheless, when valuing a company for gift and estate tax purposes, an appraiser needs to double-check his or her work against these rules (as well as Revenue Ruling 59-60) to ensure the appraisal report will be considered sound in the eyes of the federal government.

Intangible assets: Becoming a major influence on business value

With the rise of technology, intangible assets are fast becoming a major influence on business value. As such, it's important to understand just what intangible assets are and how appraisers estimate their worth.



Appraising a business

Appraisers typically rely on three approaches when valuing businesses — the asset, income and market approaches.

In general, the asset approach establishes a business's value by deducting its liabilities from the value of its assets. Under the income approach, an appraiser looks at the business's historical performance and other factors to extrapolate its future net income, which is then discounted to present value.

An appraiser using the market approach considers comparable businesses or transactions and develops multipliers based on similarities and differences between those comparators and the subject property.

Identifying an intangible

Patents, trademarks, copyrights and trade secrets constitute the types of intellectual property most often subject to valuation. However, for financial reporting purposes, the list of intellectual property can be quite long, including customer lists, in-process research and development, contracts, leases and others.

The appraiser often places a value on the owner's right to use the intellectual property while preventing or limiting others' use of the property. The value may vary by owner because some owners are better equipped to leverage the intellectual property asset than others.

Additionally, the appraiser considers the owner's property rights, the legal protections granted the owner and the likely revenue or profits to be generated by the intellectual property.

Approaches for intangible assets

When it comes to intangible assets, appraisers may apply three approaches:

1. The market approach. The appraiser finds comparable, arm's-length transactions, based on a variety of factors, including:

- The legal rights conveyed,
- Financing arrangements,
- The industry where the asset will be used,
- Physical, functional, economic and technological properties of the asset, and
- Whether any nonintellectual property assets were included in the transaction.

Once comparator transactions are selected, multipliers are devised to compare those transactions to the subject asset, and prices are adjusted accordingly.

The appraiser often places a value on the owner's right to use the intellectual property.

2. The cost approach. The cost approach bases the value on the costs the intended buyer would incur to develop or acquire the intellectual property asset. The appraiser considers several factors, such as the cost to produce a comparable asset; supply and demand for the asset; and functional, technological and economic obsolescence.

Perhaps the most critical factor under the cost approach is which cost to determine — the cost to replace the asset or the cost to reproduce the asset? Reproduction would involve assembling an exact replica of the asset, employing the same standards, materials and design originally used. Replacement involves developing a new asset with the same utility as the subject asset but possibly in a different form.

The replacement asset may be superior to the subject asset in some way, requiring an adjustment to the valuation. Further adjustment might become necessary if the replacement process took advantage of current approaches, quality and prices that were unavailable when the original asset was conceived.

3. The income approach. This approach produces a value based on the future economic benefits to be derived from the intellectual property asset. A piece of intellectual property can affect its owner's income in multiple ways, so the income approach considers several components:

- Income gained by owning the intellectual property, as opposed to not owning it (including royalties generated by licensing the asset to third parties),
- Reduced costs associated with owning the intellectual property (that is, the owner saves because it doesn't need to acquire the asset or develop a reproduction or replacement), and
- Royalties saved (that is, the amount of royalties the owner would be willing to pay to generate the profits the intellectual property is now earning).

An appraiser using the income approach to value intellectual property will usually apply either a direct capitalization or discounted future economic benefits approach. Under the direct capitalization approach, the appraiser estimates the income associated with the property for a future period and then divides that figure by an appropriate rate of return or capitalization rate.

Under the discounted future economic benefits approach, the appraiser projects income for several periods into the future and converts it to present value using a discount rate. The discount rate represents the investor's required rate of return over the projection period. Both the direct capitalization and the discounted future economic benefits rates are adjusted for a variety of factors.

Obtaining an accurate valuation

Because of the company-specific nature of many intangibles, and the lack of organized markets where intangible assets may be bought or sold, appraisers often use a combination of the three approaches to obtain an accurate value estimate. In any case, it's important for business owners and attorneys to retain qualified professionals to provide valuations likely to stand up in court or other forums.

Facts vs. assumptions play out in failed contract

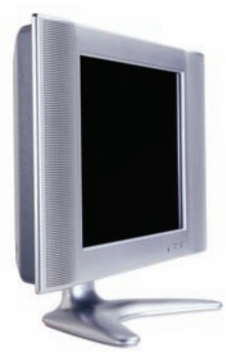
Any business venture is a risk. But, from a valuation standpoint, just how much the venturing party stands to lose when a prospective agreement falls through is a contentious issue, to say the least.

The case of *Harold and Marilyn Finkelstein v. Liberty Digital, Inc.* highlights some of the problems that can arise in such a situation. It also shows the importance of engaging a qualified and objective appraiser.

Wrong time, wrong channel

In 1999, Liberty Digital Inc. began its attempts to arrange television programming that AT&T would broadcast under a contract known as an access agreement. But Liberty couldn't get partners with products and programming to commit because of its inability to come to terms with AT&T. By December 2001, AT&T had signed a deal with Comcast instead.

The issue of how much Liberty lost when its deal with AT&T fell through arose in a dissenting shareholder action in which the Delaware Court of Chancery had to determine the access agreement's value.



Facts ignored

The court rejected the Finkelsteins' discounted cash flow (DCF) analysis because of the contract terms' uncertainty. In the court's view, the DCF model ignored, among other things:

- The time frame of commercialization,
- Liberty's inability to form a definitive agreement with AT&T, and
- AT&T's own decision to get out of the cable business.

Further, the analysis ignored AT&T's right to take a 50% interest in any interactive television channel and its right to buy Liberty's interest out at fair market value upon the channel's third anniversary.

Other problems included the rollout of a number of stations on the cable system, the absence of creation costs and an error that inflated the revenue per subscriber. Interestingly, the per-subscriber error was disclosed to the Finkelsteins' appraiser before trial, yet he refused to update his analysis and opinion.

The court commented in its opinion that such behavior "does not inspire confidence in [the appraiser's] objectivity. Rather it smacks of a stubborn desire to stick to a preconceived value number regardless of the facts."

Assumptions challenged

Taking a different approach, Liberty's appraiser assumed that the agreement would have ultimately secured Liberty some preferential treatment from AT&T. Thus, an advantage could best be approximated by assuming that Liberty wouldn't have been required to pay the launch support or carriage fees typically associated with starting new channels on a digital cable system.

The court found that the approach Liberty's appraiser took "ground[ed] his valuation in factual data." For instance, as part of his report, the appraiser analyzed 16 precedent transactions to quantify launch support and carriage fees, considering the medium (satellite, analog and digital cable television), and applied them to the specifics of the access agreement.

Reality rules

This case is a good example of why, when estimating a business contract's worth, a good appraiser will evaluate whether even the most well-established assumptions and approaches are appropriate. Every appraisal must mirror the economic realities of the marketplace and be based on sound theory and facts.