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ROUTE TO:

VALUE ADDED™

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June, 2003

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The Basics of a Good Valuation

In today's world where we are flooded with complex information, it pays to get back to the basics. In this article, we highlight some of the fundamentals of a sound business valuation so that users of business valuation services will gain an understanding of the information that should be included in every business valuation report.

The Purpose of the Valuation. The purpose of any valuation should be clearly stated at the outset because purpose can affect valuation conclusions. The purpose statement places the valuation, and its conclusion(s), in an appropriate context.

Identification of the Entity Being Valued. A valuation must clearly identify the entity to be valued. It may be apparent which company or business interest is being valued; however, there have been cases where a subsidiary was valued instead of the parent company as intended. A related circumstance occurs when the underlying assets are mistakenly valued instead of the entity which owns them.

The Valuation Date. The valuation date is known in valuation terms as the "as of" date. The valuation must relate to a point in time, because valuation changes over time. Information should be current through the valuation date, and subsequent events should be considered only as appropriate. This is particularly important when dealing with dissenting shareholder issues.

The Standard of Value. Value is described or defined in a variety of ways. Some of the more frequently used terms are fair market value, market value, fair value, investment value, intrinsic value, going-concern value, liquidation value, and book value.

Fair market value, statutory fair value, and market value are terms which typically establish legal standards for valuations. They do not always prescribe the process to be employed. The others are attempts to define value from the financial analyst's perspective. Each may incorporate one or more analytical exercises in deriving the answer. In other words, the valuation conclusions of fair market value or fair value are derived from approaches incorporating appropriate analytical techniques as well as judgment.

(Continued on Page 2, Column 2)

"In today's world where we are flooded with complex information, it pays to get back to the basics"

Valuing Employee Options

Seven Factors to Possibly Consider

Currently, companies that expense options estimate their fair value by using either the Black-Scholes model or a binomial model. SFAS 123 suggests certain modifications to these models to account for unique features of the options being valued. However, these models are generally thought to overstate value.

If a company is going to expense employee option grants, then the expense must be economically rational. Business appraisers are often called on to

(Continued on Page 2, Column 3)

IN THIS ISSUE

The Basics of a Good Valuation	1
Valuing Employee Options: Seven Factors to Possibly Consider	1
Darrell V. Arne Future Speaking Engagements	2
ESOP Ownership in S Corporations: IRS Issues Ruling on Tax Evasion Scheme	3
The Deal Expert vs. the Industry Expert	3

Darrell V. Arne Future Speaking Engagements

Tax Boot Camp for the M&A Professional

06/03/03 International Business Brokers Assn.
Orlando, FL

Charitable Trusts & Annuities: The Solution to Your Client's Financial Triangle

07/29/03 New York Society of CPAs
Nassau, NY

07/30/03 New York Society of CPAs
New York, NY

ESOPs: The Sleeping Beauty for Closely Held Businesses

06/20/03 Oregon Society of CPAs
Portland, OR

10/22/03 New Mexico Society of CPAs
Albuquerque, NM

Quantifying Personal Goodwill

10/24/03 State Bar of New Mexico
Albuquerque, NM

10/29/03 Minnesota Society of CPAs
Minneapolis, MN

Maximizing the Value of the Privately Held Company

11/03/03 International Business Brokers Assn.
Las Vegas, NV

Advanced M&A Tax Strategies and Deal Structures

11/04/03 International Business Brokers Assn.
Las Vegas, NV

**Descriptions of the courses
offered by Darrell Arne
can be found
on our website**

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The Valuation Methodology. This is a fundamental business valuation tenet: the valuation methodology or methodologies employed should match the purpose. No single valuation approach is suitable for every valuation assignment. Valuation guidelines and considerations may be very customized (acquisition valuation), subject to general guidelines (Internal Revenue Service Ruling 59-60), or mandated (dissenting shareholder valuation procedures). The appraiser often has considerable latitude in selecting the methodology. It is incumbent upon the reader to be aware of the propriety of the method employed.

Documentation. A sound valuation will have an appropriate degree of documentation. Documentation should be consistent with the nature and scope of the valuation requirement. Most valuation reports are presented as "stand-alone" documents which support and validate their conclusions. However, even less well-documented reports must be supported by analysis and file documentation.

Ability to Replicate. The careful reader of a valuation should be able to replicate the valuation result. Business appraisers who do not provide sufficient documentation to enable a replication of their answer are practicing "black magic" or some other arcane art rather than sound business valuation practices.

The Independence of the Appraiser. Valuation reports should specify who is being retained by whom. Further, any previous or existing business relationships between the entity and the appraiser should be disclosed. In addition, an appraiser should disclose whether or not there are any factors which could call his or her independence into question.

The Final Test. Understandability. Simply put, a valuation should be understandable by the lay reader as well as the professional business appraiser. In short, valuations must be built upon a solid foundation to avoid problems. ♦

Valuing Employee Options

(Continued from Page 1, Column 2)

value these options. There are seven factors that present significant differences between publicly traded options and employee stock options that may be analyzed in valuing options:

- 1) Delayed vesting
- 2) The longer maturity for the employee options
- 3) The possibility of forfeiture
- 4) Non-transferability
- 5) Dilution
- 6) Volatility estimates
- 7) In many cases, the stock received upon exercise of the employee options has not been registered and is subject to Rule 144 holding periods.

Vesting. Generally, when an employee option is granted, there is a significant period of time before the employee owns the option. The vesting period results in a period of time when the owner of the option cannot exercise which leads to a lower value for the employee option than for the publicly traded option.

Maturity. Employee option grants typically have expiration dates ten years from the grant date. Publicly traded options expire within a year of issue. While a longer period until expiration would tend to lead to a higher value for employee options, the fact that the optionholder can only realize value by exercising it somewhat mitigates this longer time to maturity.

Forfeiture. Employees who leave their jobs will forfeit any unvested options. Most option grants allow a short waiting period for vested options to be exercised after an employee leaves his job, which may force premature exercise. This tends to lower the value of employee options relative to publicly traded options.

(Continued on Page 4, Column 2)

ESOP Ownership in S Corporations

IRS Issues Ruling on Tax Evasion Scheme

Compared to Employee Stock Ownership Plan (ESOP) ownership in traditional C corporations, current law offers incremental tax benefits to S corporations. The passage of the Small Business Protection Act of 1996 (as amended in 1997) opened the door for business owners to capitalize on the tax-advantaged treatment of S corporations with ESOP ownership and was further solidified by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

The key incentive for ESOP ownership of an S corporation is the fact that distributions to the ESOP are tax exempt. The higher the ESOP's ownership stake in the company, the lower the income tax due. If the ESOP is the sole owner of the S corporation, the organization pays no income tax. While an S corporation's value does not differ from its C corporation peer, this ability to retain and reinvest profits can accelerate internal growth and allow for more rapid growth through acquisitions.

The IRS is apparently catching up to some enterprising individuals seeking additional tax benefits. Under Section 409(p) of EGTRRA, S corporation ESOPs are penalized heavily when allocating ESOP stock to "disqualified persons." Allocations to a member of a "deemed 20 percent shareholder group" (including family members) or a "deemed 10 percent shareholder" are taxed as distributions to the disqualified person and as a 50% excise tax to the S corporation. The provision is effective in 2005 for ESOPs established before March 14, 2001. In the case of an ESOP established after March 14, 2001, or in the case of an ESOP company that was not an S corporation on that date, the provision is effective with respect to plan years ending after July 11, 2000.

Several companies reportedly attempted to delay the tax impact until 2005 by using a strategy involving "off the shelf" S corporation ESOPs. First, "shell" S corporation companies without any substantial assets were incorporated prior to March 14, 2001. Then ESOPs were structured for these companies. These off the shelf ESOP companies were then sold to business owners who would initiate a corporate reorganization resulting in the shell ESOP company's ownership of the existing business. The inventors of the scheme advertised that by having established an S corporation before March 14, 2001, income would be sheltered for a few years and substantial taxes would be saved. While employees are technically eligible to participate prior to March 14, 2001, nobody actually participates until after the corporate reorganization.

Revenue Ruling 2003-6 finds that such off the shelf S corporation ESOPs were not formed "to provide substantial benefits, or substantial participation in the ownership of the S corporations, to the initial purported participants in the ESOPs. The initial employees of the entity forming the ESOP do not receive more than insubstantial benefits or more than insubstantial ownership interests through the ESOP. [...] an ESOP is not established until it is adopted by an employer for the purpose of enabling its employees to participate in a more than insubstantial manner in the ownership of the employer's business and to provide its employees with more than insubstantial benefits under the ESOP." The revenue ruling therefore does not grandfather shell company ESOPs as being established before March 2001. As a result, business owners relying on off the shelf S corporation ESOPs face the punitive tax effects of EGTRRA. The IRS further amplified its ruling by stating that other transactions will receive identical tax treatment if the effects of the transaction are similar in nature.

If you have questions about valuation issues regarding ESOPs, please do not hesitate to contact us. ♦

The Deal Expert vs. the Industry Expert

One of the most frequent issues addressed when talking with business owners relates to the financial expertise that may be appropriate for specific transaction requirements. The basic question often boils down to: *Should we hire an industry expert for this engagement, or is it preferable to hire a "deal expert" with experience in completing hundreds of transactions and engagements in a myriad of industries?*

Industry Expertise vs. Deal Expertise. There are literally hundreds of industry categories and subcategories. There are, in fact, more industry categories than there are corresponding industry specialists. Many, if not most, industry subcategories do not have industry specialists. There simply are not enough businesses in these categories to enable specialization by investment banking professionals. In small industries or industry subcategories, business owners are likely to be referred to a deal expert. If an industry is large, it is often possible to find several or too many industry experts. No matter the size of the industry, if you go with an industry expert to value and sell your or your client's business, be sure that the expert also has deal expertise. Lessons learned by way of engagements across multiple industry sectors are too valuable to lose when "your" deal needs negotiating.

Deal Expertise. Deal expertise is attained from years of hands-on experience and knowledge of financial markets. As business appraisers who are active in transactions, we are knowledgeable about valuation methods and techniques. Deal and valuation expertise also includes a working knowledge of complex financial theory. This enables us, as deal experts, to learn new industries quickly.

If you are confused about whether to choose an industry expert or a deal expert, keep the following things in mind:

(Continued on Page 4, Column 1)

Deal Expert vs. Industry Expert

(Continued from Page 3, Column 3)

- A deal expert has a wide set of relationships. An industry expert is such because they have knowledge of certain strategic buyers within the industry. However, their knowledge of possible buyers outside the industry is sometimes limited. Deal experts not only pinpoint strategic buyers within the industry but have relationships with other potential buyers.
- A deal expert has "seen it." Because of the broad experience possessed, deal experts have seen a wide set of business scenarios in diverse, as well as common, business models. This range of experience can be of great help if and when unexpected issues arise, as they almost always do.
- A deal expert is also a financial expert. A deal expert has the financial acumen to obtain the best financial outcome for the client because the deal expert possesses an understanding of the pecuniary intricacies of the deal.

Deal expertise, combined with a broad base of industry experience, is most often a preferable experience set than limited industry expertise. If a referring professional or client can obtain both sets of qualifications in one firm, so much the better.

Conclusion. Expect your advisor to be a deal expert and to have knowledge of a broad base of industries. If you are considering an industry expert versus a deal expert, you owe it to yourself to achieve the added value our deal expertise can earn for you. Let us come and visit with you when you are contemplating a transaction. You will not be disappointed. ♦

Valuing Employee Options

(Continued from Page 2, Column 3)

Non-transferability. Most employee options cannot be traded but must be exercised to achieve value, lowering the value of the employee option.

Dilution. Exercise of employee options results in the company issuing

new stock, thereby increasing the number of shares outstanding and diluting earnings per share. The result is a lower value for the employee option.

Volatility. Publicly traded options have relatively short lives and it is acceptable to either use or adjust recent historical return volatility to reflect the volatility expected over the life of the option. However, with a life of ten years, the volatility factor to be used for employee options is more difficult to estimate. The value of the option is positively related to the volatility factor.

Unregistered Stock. If the stock to be received on the exercise of an employee stock option is not registered, then the holder of the stock must hold it for one year before it can be sold in the public markets. During that one year holding period, the stock price could decrease, thus reducing the value of the option.

Achieving a valuation conclusion that is economically rational and defensible is the goal of every valuation. To ensure the value of your employee stock options are economically rational and comply with the standards of SFAS 123 and 148, contact us today. ♦

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