

# VALUE ADDED™

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## Do Taxes Matter?

As business appraisers, we know that significant business decisions revolve around tax consequences. Basic economic courses have described the marginal utility of that extra dollar of income when viewed from its after-tax perspective.

Taxes do matter, and the typical balance sheet and income statement adjustments which business appraisers make in analyzing private company financial statements are always tempered by the impact of implicit taxes. Additionally, the use of market-derived capitalization rates focuses our attention on after-tax earnings, since most such capitalization rates are based on public, taxable entities.

The most common balance sheet adjustments we consider include:

1) marking assets or liabilities to fair market value; and 2) recognizing off-balance sheet items that enhance or impair value. In adjusting the balance sheet, we review marketable securities,

receivables, LIFO inventories, net fixed assets, intangibles and interest-bearing debt if it carries rates significantly higher or lower than current market rates. Contingent liabilities may also be considered. Marking these assets to their fair market value on a pre-tax basis helps provide a better picture of the gross assets. However, from a valuation perspective, the gross change in adjusted net asset value should be tax effected in order to approximate an indication of underlying net asset value.

Pre-tax analytical adjustments to the income statement can occur at the gross margin level, among operating expenses or among "other" income and expense items. The goal, of course, is to determine a level of earnings which indicates the company's sustainable earnings power. When historical earnings are used as a prognosis for future performance, changes will be based on management, economic and marketplace decisions, so it is important to temper historical results with management interviews. Upon adjusting these pre-tax profitability figures, they are generally tax effected at a federal and state marginal tax rate.

The analysis of a Sub Chapter S corporation presents its own unique challenges. Treated as a corporation, an S corporation's earnings are generally taxed only at the shareholder level. Since the valuation assignment is typically to determine fair market

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## Tax Court Makes Plan Fiduciary Responsibilities Clear Once Again

A Tax Court decision (*Eyler v. Commissioner*, T.C.M. 1995-123) reemphasizes the importance of a well-documented independent valuation report, a thorough due diligence review and the exercise of good faith in Employee Stock Ownership Plan ("ESOP") transactions.

The case of *Eyler v. Commissioner* is a memorandum opinion filed in March 1995, in which the majority shareholder of a corporation was assessed a \$12.5 million excise tax on a prohibited transaction because the sale of the company's stock to the ESOP was priced greater than adequate consideration, or an amount in excess of fair market value.

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value, many appraisers consider the universe of buyers to include corporate entities among prospective purchasers. On this basis the value of the business must assume normal income taxes which the hypothetical willing buyer would have to pay. The earnings of S corporations are generally adjusted to reflect a normal income tax at the corporate level. Since the prospective willing buyer may not qualify for the S election, the company has the same value whether the company has chosen S tax status or not.

Finally, a more practical reason for tax effecting earnings adjustments relates to the capitalization rate or multiple to be applied to those earnings. If the appraiser is dealing strictly with pre-tax earnings, then the capitalization rate or multiple must be appropriate for that earnings stream. Many appraisers utilize a debt-free valuation approach by capitalizing EBITDA (earnings before interest, taxes, depreciation and amortization) and subtracting the debt. But, EBITDA multiples are not readily available and can easily be misinterpreted from a narrow data base.

On the other hand, the work of Ibbotson Associates, which describes small company common stock risk premiums on a historical basis, is derived from a compilation of publicly traded, fully taxable market return data. When Ibbotson data is used, it is appropriate to apply it to the proper income stream, which is after-tax earnings. The Capital Asset Pricing Model is also based on market-derived data, again recognizing earnings on an after-tax basis.

**Summary.** Taxes do matter. The adjustment of balance sheets to reflect economic reality should recognize the impact of taxes on such adjustments. The use of market-derived capitalization rates and multiples is appropriate only when applied to the properly matched income stream. ♦

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## Tax Court Makes Plan Fiduciary Responsibilities Clear Once Again

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While the case addressed a number of issues that would be of interest to advisors and plan trustees (such as the harsh penalties involved; marketability discounts; and the impact on value of subsequent purchases, IPO pricing and ESOP debt) the Court's decision ultimately hinged on a two-part test of 1) whether the ESOP paid no more than fair market value for the company's stock; and 2) whether the price paid was determined in good faith.

The facts of the case and the decision bear a review for those considering selling stock to an ESOP as well as fiduciaries and professional advisors. The case emphasizes the importance of well-documented independent appraisals in ESOP transactions and the demonstration of good faith and fair dealings.

A review of the pertinent facts in the case will give us some guidance as to the Court's thinking and the road traveled to reach its conclusion. The company, Continental Training Services, Inc. ("CTS"), was a vocational school that trained truck drivers and heavy equipment operators. It was owned by its sole shareholder who also served as the CEO and Chairman of the Board.

In early 1986, after rejecting an acquisition offer, management decided to take the company public. Prudential Bache Securities and Raffensperger, Hughes and Co. were retained as underwriters and began a due diligence review to determine an estimated offering price. After the due diligence process, which consisted of a review of CTS's financial records, a visit to the company's facilities, interviews

and discussions with management and an evaluation of economic and financial forecasts, an offering price in the range of \$13 - \$16 per share was established.

During 1986, a number of adverse factors surfaced which were disclosed in the preliminary IPO prospectus. At the time of the due diligence review, the company was under investigation by the California Department of Motor Vehicles for alleged fraudulent practices and misleading advertising. The relief sought was a revocation of CTS's license. In addition, the U.S. Department of Education was investigating the company, focusing their investigation on the same or similar areas. Another pending factor was a planned change in the method of disbursing guaranteed student loans, which would have a significant negative impact (\$5 million reduction in available cash) on the company's cash flow.

The underwriters attempted to market the IPO but, because of declining market conditions, were unable to generate a "circle of interest" sufficient to take the company public. CTS, advised to wait and see if the market would improve, postponed the offering.

The failure of the public offering resulted in the formation of the ESOP in late December 1986. The Director of Human Resources was named the Trustee and a Plan Committee was appointed. The ESOP purchased 13.7% of the company's shares from its sole shareholder in a \$10 million leveraged transaction at a price of \$14.50 per share. The loan was guaranteed by the company and the selling shareholder. No independent financial advisor was engaged to assess the reasonableness of the transaction or the price paid by the ESOP.

Instead, the company's Board relied on the verbal opinion of the CFO and the price range established earlier in the year by the underwriters in the abandoned IPO attempt. The Court

did not consider the company's efforts to establish the fair market value of the stock to be a good faith effort; nor did it consider the price paid "adequate consideration."

Since the case involved a claim against a taxpayer who was not considered to be acting in a fiduciary capacity relative to the ESOP, the Court provided the opportunity to avoid the excise tax liability by establishing either 1) that the stock was acquired at a price no greater than fair market value; or 2) that the ESOP fiduciaries acted in good faith in determining the price.

In an effort to prove that the stock was acquired at a price that did not exceed fair market value, the taxpayer retained an expert witness for the trial. The expert witness did not prepare an independent appraisal, but based his opinion largely on his belief that 1) the value placed on the stock for IPO purposes was a current and reliable valuation; and 2) the CFO's opinion of the price was fair.

The Court rejected the expert's opinion because he did not independently determine the viability or content of the documents he reviewed in expressing his opinion. Although the expert agreed that the method used by the underwriters was an appropriate valuation methodology, the Court noted that he made no analysis of basic information necessary for an appraisal. The Court also considered subsequent transactions by members of the Board to acquire stock (at \$14.50 per share), but rejected these transactions as arms' length because of interest-free, bridge financing provided by the taxpayer.

In considering whether the price paid constituted fair market value, the Court also noted a number of other factors, such as the general downturn in the public markets toward the end of 1986 and the potential impact of the \$10 million ESOP loan on the company's financial condition and earning capacity.

As to the good faith test, since the Department of Labor's Proposed Rules Regarding Adequate Consideration were not issued until 1988, the Court interpreted the good faith effort under the general duties of fiduciaries in Section 404 of ERISA, and concluded that the Board's action did not rise to the exacting level of prudence imposed by ERISA. The Court noted that fiduciaries must not blindly rely on expert advice and that the Board members appeared to do so with little attempt to reach their own conclusions. There was also a question as to whether the Board had sufficient time to independently evaluate the fair market value of the stock purchased by the ESOP, since the underwriters were still attempting to market the IPO as late as the first week in November 1986 and the taxpayer wanted to sell his stock before the end of calendar year 1986. Thus, the Court found that the fiduciaries failed to satisfy their obligations.

While we recognize that Tax Court Memorandums are not precedential, they are instructional and helpful in assessing the lessons plan trustees and advisors can learn from *Eyler*:

- For ESOP transactions, prepare a well-documented appraisal as of the transaction date.
- Follow the guidance of Revenue Ruling 59-60.
- Be sure that the valuation analysis is presented to the plan trustee or named fiduciary.
- Review the valuation analysis with the trustee or fiduciary in depth.
- Do not short-circuit the steps of the mandated analysis in the heat of transaction deadlines.

These are not new lessons, but their repetition will help practitioners reexamine their activities in light of current court opinions and "real world" transactions. If you have a question about an ESOP appraisal, please call. ♦

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## The Proper Accounting Treatment for Stock Options

### Statement of Financial Accounting Standards No. 123

Accounting for stock-based employee compensation plans is a pervasive subject that affects both public and non-public entities. Awarding stock-based compensation is an effective way of attracting and retaining key executives and motivating employees; however, determining how to account for this type of compensation has been a source of controversy. After eleven years of deliberation, in October 1995 the Financial Accounting Standards Board issued its new accounting standard, Statement 123, which addresses the appropriate accounting treatment for employee stock options.

Previously, under the Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25), companies could award certain stock-based compensation plans to employees without incurring a charge (e.g., if the exercise price equaled or exceeded the market value of the underlying security).

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### SPEAKERS' BUREAU

Members of this firm often participate in local and national speaking engagements, which include group seminars and speeches for attorneys, CPAs, CEOs, and other financial advisory professionals interested in topics relating to Business Valuation. Please call for further information or to discuss a specific speaking engagement.

Under Statement 123, a company may opt to use the new "fair value" method of accounting to measure the compensation cost for its stock options and other equity instruments in its financial statements; or the company may elect to use the previously established "intrinsic value" method set forth in APB No. 25. If the latter alternative is selected, the company is required to disclose the pro forma effect stock option grants would have had on net income had the "fair value" method been adopted.

Statement 123 provides a standard that applies to all transactions in which a company awards shares of stock, stock options or other equity instruments to its employees. This new fair value-based method measures compensation cost at the issued date based on the value of the award and is recognized over the award's service period.

In regard to stock options issued by a public entity, the fair value is

determined using an option-pricing model such as the Black-Scholes or a binomial model that considers the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock and the expected dividends on it and the risk-free interest rate over the

expected life of the option. The fair value of an option estimated at the issued date is not affected by changes in the price of the underlying stock or its volatility, the life of the option, dividends on the stock or the risk-free interest rate.

The fair value of a stock option granted by a non-public entity is determined by the discussion described above, except that a non-public entity may disregard the expected volatility of its stock over the expected life of the option, which results in an option's minimum value. This exception to the "fair value" requirement is permitted because of the limited trading history of a privately

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held company, which precludes the ability to establish a volatility assumption for its stock. The company can compute "minimal value" by using an acceptable option-pricing model and applying a stock price volatility assumption of zero.

Statement 123 includes suggestions on adjusting option pricing models to handle non-transferable options, delayed vesting and other matters tending to complicate the valuation analysis. Care and judgment are required in developing inputs to the option pricing model and in interpreting the calculated values. Any use of the models must be tailored to the prevailing facts, circumstances and specific terms of the option plan.

Ultimately, most companies that issue employee stock options will continue to recognize Opinion 25 to account for this type of compensation. Nevertheless, these companies are still required to calculate the "fair market value" of these stock options in a footnote.

For more information or to discuss a valuation issue in confidence, please give us a call. ♦

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