

Staying on top of Evolving Requirements in Valuation

Alex Hodgkins, Managing Director, Arcstone Partners

In the last few years a proliferation of regulatory requirements has substantially increased the complexity involved in incorporating equity participation into compensation plans for employees and service providers, both for public and privately-held companies alike. For the first time, terms like “409A”, “123R”, “valuation”, “Practice Aid”, “qualified appraiser”, and “safe harbor methods” are now inevitably part of the vocabulary of most compensation professionals, although there is still substantial debate and confusion about just how companies should go about achieving compliance in developing their compensation policies and practices. In this article we will attempt to (1) identify the primary constituencies who have developed the requirements as they currently stand, (2) discuss best practices for achieving compliance, (3) identify some of the more significant issues being encountered in implementation, and (4) provide recommendations on how to stay current on the rapidly evolving requirements.

The introduction of Internal Revenue Code Section 409A and Statement of Financial Accounting Standards (SFAS) 123R “Share Based Payment” has caused a wave of discussion in recent months as companies scramble to implement policies that are in compliance. The IRS added Section 409A to Section 885 of the Jobs Creation Act of 2004 and finalized the regulations in April, 2007. The code incorporates requirements with respect to discounted stock options and stock appreciation rights (SARs) that are treated as deferred compensation. Under Section 409A, stock options that have an exercise price less than the fair market value of the underlying stock as of the grant date could result in adverse tax consequences for the option recipient. The gain is subject to taxation at the time of option vesting rather than the date of exercise. Further, the amount is subject to a 20 percent additional “penalty” tax on the option holder as well as an interest charge. Taken together, the consequences for noncompliance with Section 409A are significant. Note also that these consequences are directed at the individuals holding the stock options, not at the company that issued them.

The 409A requirement, while lengthy and complex, outlines some reasonably clear approaches on how compensation professionals can develop compliant policies regarding the valuation of their respective company’s equity. Importantly, these presumptive methods, dubbed “safe harbors”, shift the burden of proof of noncompliance to the IRS. Effectively, this means that a company that has employed a

safe harbor method to value the price of its stock options must be shown by the IRS to have been “grossly unreasonable” in calculating the fair market value of the underlying security.

These safe harbor methods, which are discussed extensively in a wide variety of publications promulgated by the legal and accounting communities, include the “illiquid start-up”, “binding formula”, and “independent appraisal” approaches. The presumptions must incorporate the evaluation of a number of factors which include (i) the value of tangible and intangible assets of the company, (ii) the present value of future cash flows, (iii) the public trading price or private sale price of comparable companies, (iv) control premiums and discounts for lack of marketability, (v) whether the method is used for other purposes, and (v) whether all available information is taken into account in determining value.

While many companies have been successful in implementing one of these safe harbor methods, many compensation professionals struggle with the concept of shifting the burden of proof as well as the assessment of what the true exposure may be for the option recipient in the event the valuation conclusion is challenged. Many have chosen to employ the services of a third-party firm to perform a valuation, as this approach is commonly believed to offer the most effective protection. However, even the “independent appraisal” approach has presented a number of challenges, including how to identify competent professionals and how to understand the standards to which 409A valuations will be held. Because a number of professional organizations provide valuation training and credentials, there is no universally accepted governing body. This has caused some confusion as to what constitutes a competent and capable valuation professional. To make matters worse, the valuation community has not yet fully developed a robust body of knowledge concerning valuations performed for these purposes. This body of knowledge is traditionally developed over a period of time as a result of a collective contribution of best practices and valuation theory from practicing professionals, task forces, valuation industry organizations, and – importantly – case law emanating from court decisions concerning valuation analyses performed in similar situations which involve similar facts and circumstances. Finally, as the regulations are quite new, no companies have yet had to defend their 409A valuation conclusions with the IRS.

However, there is good news. Valuations for tax purposes have been conducted for many years in a wide variety of situations. As a result, there is a reasonable amount of information available on how to conduct a valuation suitable for presentation to the IRS,

as well as on how the IRS currently assesses the competency of valuation professionals. Going beyond the simple “safe harbor” compliance of an independent appraisal, compensation professionals should seek to secure a “qualified appraisal” from a “qualified appraiser” as defined in tax documents and recent court rulings in order to fully enjoy the additional protections offered by shifting the burden of proof.

To obtain guidance on the most recent legislation and statements of position from the IRS, one must look to recent changes in the reporting requirements and penalties relating to non-cash contributions for charitable purposes. Specifically, Section 1219 of the Pension Protection Act of 2006, in addition to increasing penalties on under- and over-valuations, imposes new requirements for what constitutes a “qualified appraisal” by a “qualified appraiser” for a gift of non-cash property of more than \$5,000. In the course of filing, the donor must now attach an appraisal summary (Form 8283) to his or her tax return. The “qualified appraisal” must include the following:¹

- Description of the property, including its physical condition (if relevant)
- Date (or expected date) of the gift
- Terms of the gift, including any limitations
- Identity and qualifications of the appraiser
- Statement that the appraisal was prepared for income tax purposes
- Preparation date
- Appraised fair market value
- Valuation method
- Specific basis for valuation
- Appraiser’s declaration

In recent presentations, representatives of the IRS have mentioned that the requirements were developed after a review of the valuation standards of the various valuation professional organizations as well as the Uniform Standards of Professional Appraisal Practice (USPAP), which serves as the underlying framework for a number of other appraisal disciplines including real property, personal property, and machine and equipment. More specific detail on the internal requirements of IRS personnel in reviewing and developing valuation analyses can also be found in the publication

¹ Pub. 561, “Determining the Value of Donated Property”, Department of the Treasury, Internal Revenue Service (Rev. October 2005), p. 9

“Business Valuation Guidelines”, which was developed by the IRS in 2004 and revised and re-released as of July 27, 2006.²

The legislation also tightens the definition of what constitutes a “qualified appraiser.” The current set of standards encompassed by the definition include the following:³

- Has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements prescribed by Treasury regulations.
- Regularly performs appraisals for which the individual receives compensation.
- Can demonstrate verifiable education and experience in valuing the type of property subject to the appraisal.
- Has not been prohibited from practicing before the IRS at any time during the three years preceding the appraisal.
- Meets any other requirements prescribed by Treasury regulations.

There are essentially four recognized professional appraiser organizations. These include:

- American Institute of Certified Public Accountants (AICPA)
Valuation Credential Offered: ABV
- American Society of Appraisers (ASA)
Valuation Credentials Offered: ASA, AM
- Institute of Business Appraisers (IBA)
Valuation Credentials Offered: CBA, BVAL, AIBA
- National Association of Certified Valuation Analysts (NACVA)
Valuation Credentials Offered: AVA, CVA

While there is some debate regarding which credential is best, all of the above credentials currently provide sufficient evidence of minimum education in the profession for purposes of satisfying the “qualified appraiser” requirement under current IRS regulations.

² The complete set of guidelines can be viewed at <http://www.irs.gov/irm/part4/ch43s04.html>

³ Pub. 561, “Determining the Value of Donated Property”, Department of the Treasury, Internal Revenue Service (Rev. October 2005), p. 10

In a recent decision, *Herbert V. Kohler, Jr. v. Commissioner of Internal Revenue*, United States Tax Court, T.C. Memo 2006-152, July 25, 2006, the court determined that the burden of proof was shifted from the taxpayer to the IRS. Under Internal Revenue Code Section 7491 a taxpayer may shift the burden of proof to the government on questions of fact providing they satisfy certain conditions. The burden of proof is only relevant when the facts are not in dispute and not when the issue is a question of law. Valuation issues are primarily issues of fact. Under Section 7491 the taxpayer can shift the burden of proof provided they satisfy the following conditions:⁴

- The taxpayer introduces credible evidence with respect to the issue,
- The taxpayer has complied with the requirements to substantiate any items under the code and regulations.
- The taxpayer has maintained all records under the code and regulations.
- The taxpayer has cooperated with reasonable IRS requests for witnesses, information, documents, meetings, and interviews.

In the context of the Kohler case, the court ruled that the burden of proof had been shifted to the IRS because the petitioner had introduced credible evidence, established that they had substantiated items, maintained required records, and had cooperated with the IRS.

Both parties submitted expert reports providing valuations of the petitioner's stock. In reviewing the reports and the qualifications of the experts the court noted:⁵

“Although [the respondent's expert] has a doctorate from the University of Minnesota and is a chartered financial analyst, he is not a member of the American Society of Appraisers (ASA) nor the Appraisal Foundation. [The] report also was not submitted in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP). [The respondent's expert] did not provide the customary USPAP certification, which assures readers that the appraiser has no bias regarding the parties, no other persons besides those listed provided professional assistance, and that the conclusions in the report were developed in conformity with USPAP.”

⁴ Bravo, Stephen J., “The Burden of Proof”, *Business Valuation Review*, Winter 2006, p. 136

⁵ *Herbert V Kohler, Jr. v. Commissioner of the Internal Revenue*, T.C. Memo. 2006-152 (U.S. Tax Court, July 25, 2006) p. 28

In contrast, ultimately deciding for the taxpayer, the court stated that it was impressed with the valuation methodologies utilized by the taxpayer's experts as well as the fact that the expert was a certified appraiser. This conclusion highlights the importance of both *appraiser* and *appraisal*. In other words, not only is it important to use reputable, qualified appraisers, but it is also critical that such professionals follow generally accepted valuation standards to craft robust appraisal reports.

A significant complication arises when companies that comply with IRC 409A also attempt to comply with Generally Accepted Accounting Principles (GAAP). This complication arises from the fact that option expenses under the Statement of Financial Accounting Standards (SFAS) No. 123R, "Share Based Payment" require a calculation of the cost of stock options, and one variable in such calculation is derived in the 409A analysis. It follows that valuation reports completed in the context of 409A are often also used to assist in calculating option expenses under SFAS 123R. However, valuations that are derived specifically to satisfy 409A may not be conducted in a manner that is consistent with GAAP standards of value. When this is the case, many auditors will outright reject the company's 123R calculations. This is deemed "regulatory collision" and has been the source of significant and continuing debate within the valuation community.

In developing an analysis that meets GAAP requirements, a valuation report must also take into consideration the requirements promulgated under the Fair Value for Financial Reporting standards that were developed by the Financial Accounting Standards Board (FASB) and implemented by the accounting and audit community. Substantive guidance for performing valuations for these purposes has been provided through a Practice Aid published by the AICPA titled "Valuation of Privately-Held Company Equity Securities Issued as Compensation." The Practice Aid, which was developed in 2004, provides significant insight into most aspects of valuation report development and analysis, although the publication does caution that it "has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA or the Financial Accounting Standards Board and has no official or authoritative status." With that said, most accounting firms and audit practitioners reference the Practice Aid in reviewing the reports utilized in SFAS 123R analyses. The standard of value thus promulgated by GAAP practitioners has significant, though not irreconcilable, differences from that promulgated by the IRS.

In completing a review of a valuation report developed by a third party, the auditors must abide by the Statement of Auditing Standards (SAS) No. 73, "Using the Work of a

Specialist.” This statement provides guidelines for independent auditors who seek the assistance of a specialist to perform audits of financial statements prepared in compliance with generally accepted accounting principles. The statement defines what constitutes a specialist. This includes persons or firms that possess special skills or knowledge in particular fields other than accounting or auditing. They include actuaries, appraisers, engineers, environmental consultants, geologists, and others. Valuation is mentioned as a matter which may warrant the use of a specialist. The auditor is required to consider certain elements in determining whether the specialist possesses the necessary skill or knowledge in the particular field. These elements include:⁶

- The professional certification, license, or other recognition of the competence of the specialist in his or her field, as appropriate.
- The reputation and standing of the specialist in the views of peers and others familiar with the specialist's capability and performance.
- The specialist's experience in the type of work under consideration.

The AICPA Practice Aid provides some suggestions on additional criteria which should be evaluated as well:⁷

- The specialist's experience in valuing privately issued securities and in particular those of entities similar to the enterprise, including whether the specialist has valuation experience in the enterprise's industry or is otherwise knowledgeable about the industry. [Management] also may consider the specialist's knowledge and experience with respect to value allocation methods such as the three discussed in Chapter [XX], "Valuation of Preferred Versus Common Stock."
- Whether the specialist is familiar with the guidance in the Practice Aid.

Often, auditors will defer the review of the valuation report to the accounting firm's own internal valuation staff. In conducting their review, these professionals will often make use of their firm's specific positions on various aspects of valuation theory and will work with the third party specialist rendering the opinion in reconciling any issues that arise.

⁶ Statement on Auditing Standards (SAS) No. 73, "Using the Work of a Specialist", Auditing Standards Board, 1994, p. 546

⁷ Audit and Accounting Practice Aid Series, "Valuation of Privately-Held-Company Equity Securities Issued as Compensation", American Institute of Certified Public Accountants, 2004, p. 83

In many cases, valuation professionals will base their positions upon interpretations of SEC comments regarding cheap stock issues.

There are a number of issues that emerge in the context of developing reports that fulfill both tax and financial reporting requirements. The disparities flow from the fact that the differing sets of requirements fall under two different standards of value. A standard of value, as defined by the International Glossary of Business Valuation Terms, as adopted by all of the aforementioned professional business valuation associations, is “the identification of a type of value being used in a specific engagement.” The standard of value used for tax purposes is known as Fair Market Value.⁸ The standard of value used for financial reporting (or GAAP) is Fair Value.⁹ While both the IRS and the SEC have commented that these standards are in effect similar, neither has officially stated a position on the matter. What is clear is that there are certain aspects of the reporting requirements that many valuation professionals believe are at odds. Specific disparities have been proposed to exist in several areas including, (i) the nature of the interest being valued, (ii) the magnitude of certain discounts and the methods through which these discounts can be quantified, and (iii) the manner in which the resultant enterprise value of the company should be allocated. While a detailed discussion regarding these issues is beyond the scope of this article, it is worth mentioning the nature and circumstances behind the disparities.

In the first instance, the nature of the interest in a 409A analysis typically relates to a specific individual receiving the compensation. The size and the restrictions attached to these individual interests can potentially contribute to certain adjustments when evaluated through current prevailing valuation practices for tax purposes. However, under SFAS 123R the option grants are analyzed from the perspective of the grantor. As a result, the characteristics of the interests at the level of the individual are deemed irrelevant. Further, current accounting guidance suggests that adjustments related to the size of particular interests (known as “blockage” discounts) are strictly prohibited.¹⁰

⁸ According to Revenue Ruling 59-60 the definition of Fair Market Value is “the price at which property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the facts”

⁹ According to Statement of Financial Accounting Standards (SFAS) No. 157, the definition of Fair Value is “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”

¹⁰ Statement of Financial Accounting Standards (SFAS) No. 157, “Fair Value Measurements”, Financial Accounting Standards Board, September 2006

Relating to the second issue, under the Fair Market Value premise, valuation practitioners often apply discounts for a lack of marketability to equity interests in privately held companies. Such discounts are designed to adjust for the costs and risks of not having a market where the interest being valued can be freely traded. Traditionally these discounts have been developed through an examination of generally accepted empirical studies involving restricted stocks of public companies and/or equity values before and after companies complete an initial public offering. The courts have supported the thoughtful use of these studies on numerous occasions in the tax realm and as a result they have become widely used for those purposes. With that said, the financial reporting community has consistently questioned the use of these studies and many auditors have shown a strong preference for other methods, the most common of which include “protective put” and “put-call collar” methods.

The final major disparity involves the allocation of the estimated enterprise value. The AICPA Practice Aid presents the three most common approaches – the Current Value method, the Option Pricing Method (OPM), and the Probability Weighted Expected Return Method (PWERM). The core of this issue rests in the nature of the allocation. While the first is focused on the present, the latter two methods incorporate a forward looking element to the analysis. While the Current Value method essentially captures the traditional approach to allocation, the latter methods attempt to capture the potential option value an interest carries. Said differently, while the Current Value method may render a conclusion that suggests the value of the common stock may, for instance, be worthless as the result of certain preferences and participation of preferred stockholders, the OPM and PWERM methods provide a quantifiable answer to the rhetorical point, “if the stock is worthless, then give it to me.” Clearly, if the expectation is that the company may be worth some amount which will create value for the common stockholders, one would be expected to hold onto such an interest.

The reality is that valuation standards for equity compensation are still evolving, and evolving rapidly. This in turn can make the compliance process for compensation professionals a daunting task. Many believe the myriad of variables and assumptions make the task too complex for standards to exist at all. Some would rather see the implementation of a vastly simplified approach or an abandonment of these requirements all together. However, market forces on both the tax and financial reporting realms make it highly unlikely that these requirements will be either simplified or abandoned. The IRS has assembled a valuation and appraisal staff exceeding 300 professionals, and has made a clear commitment to focusing on lost tax revenues from

transactions involving privately held securities. This is exemplified by their recently authored Business Valuation Guidelines text, the final passages of IRC 409A, and the additional requirements and penalties set forth by Section 1219 of the Pension Protection Act of 2006.

On the financial reporting side, the forces driving increased regulation of valuation issues are also significant. The issuance of SFAS No. 157, “Fair Value Measurements”, and SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities”, has established a framework for Fair Value–based financial reporting. These statements incorporate a hierarchy of methodologies to be used in quantifying assets and liabilities. In doing so they extend and expand the role of valuation in financial reporting and solidify the role of valuation in the accounting discipline, which was first introduced in the process of allocating purchase prices across assets, both tangible and intangible, in business acquisitions through the introduction of SFAS No. 141, “Business Combinations.”

Conclusions and recommendations can be drawn from the above analysis. Valuations for compliance with IRC 409A and/or SFAS 123R should be conducted by a valuations provider:

- with a credential from a recognized body,
- that has experience in performing similar work,
- which understands the differences between valuations for tax and financial reporting,
- that has dealt with auditors regarding the issues before, and
- is proficient in utilizing the methods promulgated in the AICPA Practice Aid.

It is further recommended that company auditors approve valuation providers in advance of engagement, in the context of complying with SAS 73 requirements.

Staying on top of the evolving requirements in valuation is a significant challenge. It is recommended that management keeps an ongoing dialogue with legal counsel, auditors and valuation professionals. Periodic updates to company valuations should be accompanied by periodic recalibrations of understanding.