Viewpoint on Value

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Accept no shortcuts when valuing ESOs

Employee stock options (ESOs) aren't just for start-ups and high-tech firms anymore. As the economy continues to limp along, all types of businesses are compensating employees with stock options in lieu of cash bonuses. ESOs not only save on cash, but they also provide an incentive to increase profits and build value.

However, the administrative side of issuing ESOs can be a headache — and sometimes lead to a minefield of IRS and investor inquiries. Even worse, unsuspecting employees may be stuck with tax liabilities if their options are valued incorrectly. Fortunately, valuation professionals can help guide businesses through the ESO minefield.

Why value options?

Stock options give the recipient the right — but not the obligation — to purchase stock at a predetermined "exercise" price within a limited time frame. Obviously, the higher the stock price goes, the more valuable an employee's options become. Although this article focuses on options given to managers and C-level employees, they may also be given to directors, consultants and other service providers.

Valuing ESOs is important for two reasons:

1. Accounting purposes. As options vest, they must be expensed at their fair value on the grant date — not the exercise date — according to Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 718, *Compensation — Stock Compensation* (formerly FASB Statement No. 123R). Usually, a deferred compensation liability also is recorded on the balance sheet, as well as deferred tax items, if applicable.

2. Income tax purposes. Internal Revenue Code (IRC) Section 409A states that employees must pay income taxes, plus a 20% excise tax, on the value of stock options granted "in the money" — if there isn't a substantial risk of forfeiture, and if the options weren't previously included in gross income. Options are in the money if the exercise price is set below the fair market value on the grant date. The tax liability is especially burdensome because employees don't receive any cash from their employers when they're issued ESOs.

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In general, as long as the exercise price is at or above the grant-date fair market value and all other 409A requirements are met, an ESO is exempt from Sec. 409A. If exempt, compensation is deferred until the employee exercises the option.

How are options valued?

Valuators using option-pricing models consider the following elements:

- Exercise price,
- Expected term (time until expiration),
- Value of the company's stock on the grant date, and
- Expected stock-price volatility or, for private companies, the expected volatility of a comparable market-pricing index.

All else being equal, higher values are assigned to options with lower exercise prices, longer terms,

higher grant-date stock prices and lower volatility. Valuation models also consider the company's expected dividends and the risk-free rate.

The Black-Scholes model is the best-known tool for pricing options. But because it's based on calculus, this model can be hard for auditors, employees, jurors and other laypeople to understand. In addition, the model can't take into account the specific characteristics of private company ESOs, including vesting schedules, transfer restrictions, change-in-control provisions, and suboptimal employee investing behavior. As a result, the Black-Scholes formula tends to overvalue private-company ESOs.

By comparison, binomial and trinomial lattice models can take these limitations into account and generate more reliable, defendable ESO values. Lattice models use simple algebra and can be depicted with intuitive decision trees.

Why does stock price matter?

Some inputs, such as the exercise price and expected term, are relatively straightforward. But stock price is a more ambiguous ingredient when valuing private companies' options, regardless of whether the Black-Scholes or a lattice model is used.

Appraising stock is especially cumbersome when multiple ownership layers exist. And private companies actually issue *new* shares when employees exercise their options, thereby diluting the existing shares. This creates a circular reference in the model, because stock price is an input in the value of stock options. Fortunately, experienced appraisers know how to use spreadsheet formulas as aids in determining the most appropriate value.

The IRS requires companies to determine the fair market value of stock through "the reasonable application of a reasonable valuation method." Acceptable methods for valuing private stock include the cost, market and income approaches, according to FASB and IRS guidance. Other relevant factors, such as discounts for lack of control and marketability, also may be considered.

Who values ESOs?

No matter how experienced, most in-house accounting personnel lack business valuation training and experience using complicated option-pricing models. So, most auditors will ask for a formal outside appraisal report before signing off on their clients' deferred compensation plans.

IRC Sec. 409A doesn't specifically require that an independent appraiser estimate the fair market value of a taxpayer's stock. But valuations made by an independent outside appraiser within 12 months of the grant date generally fall under the Sec. 409A safe harbors. They're afforded a "presumption of reasonableness" and shift the burden to the IRS to prove that the valuation method was "grossly unreasonable." If a company doesn't use an independent appraiser, it will bear the burden of proving its valuation methodology reasonable.

How should you proceed?

ESOs remain a useful tool for attracting and retaining key talent, but businesses should be aware of the accounting and tax requirements involved — and the potential risks that are posed. Reasonable stock and option valuations prepared by independent valuators can limit exposure for employees, plan sponsors and board members. ●

All the right questions

Is your expert — or the opposing expert — qualified?

When choosing a business appraiser, you want the best. But it's important to remember that not all experts are created equal. How do you know whether the appraiser you're about to hire has what it takes — or whether an opposing expert has the required expertise?

Identify qualified experts

Obviously, valid valuation credentials should be a top consideration when hiring an appraiser. Look for experts who make valuation their top priority — part-timers might not be current with the latest trends, research and case law.

Find out whether your appraiser belongs to any business valuation professional organizations such as the American Society of Appraisers (ASA), the Institute of Business Appraisers (IBA), the National Association of Certified Valuators and Analysts (NACVA) or the American Institute of Certified Public Accountants (AICPA). Appraisers should have current business valuation credentials and be up-to-date on membership dues and continuing professional education (CPE) requirements.

Before hiring, ask experts a few questions, such as:

- How many years have you worked as a valuator?
- What percentage of your time is spent valuing businesses?
- Do you have experience valuing companies in the same industry as the subject company?
- How many valuation reports have you performed in your career? Over the last year?
- Have you ever testified in court? If so, what's your track record?

In addition, ask whether your potential appraiser specializes in a particular valuation niche. For example, someone who works primarily for nonmonied spouses in divorce cases might be perceived as a hired gun.

Improve questioning

Astute questioning can be invaluable when dealing with opposing experts in deposition and at trial. Guided by a valuation expert, you can frame deposition and trial questions around certain common denominators. After asking about the opposing expert's qualifications, delve into more detailed inquiries, such as:

Basic business valuation. Consider giving the opposing expert a pop quiz on valuation basics. The expert should be able to define fair market value and know the three approaches (cost, market and income) to valuing a business. The opposing expert also should know the factors to consider when valuing a business under Revenue Ruling 59-60, including the nature and history of the business, the economic and industry outlook, the earnings capacity, and the comparable transactions.

What's a *Daubert* challenge?

The 1993 *Daubert v. Merrell Dow Pharmaceuticals* decision instructs judges to consider four nonexclusive factors when determining whether expert evidence meets minimum standards of reliability:

1. Has the expert's theory or technique been tested? Can it be tested?
2. Has the theory or technique been subject to peer review or publication?
3. What is the theory's or technique's known or potential error rate?
4. Is the theory or technique generally accepted in the relevant scientific community?

The Supreme Court's 1999 decision in *Kumho Tire Co. v. Carmichael* confirmed that *Daubert* applies to both scientific and nonscientific evidence, including testimony by financial and business valuation experts. Since *Daubert*, courts have raised the bar concerning admissibility of expert witness testimony. To ensure your valuation experts are allowed to testify, discuss the *Daubert* standards with them.

If the opposing expert hesitates or makes mistakes while answering these questions, he or she may be unprepared or unqualified. If the mistakes are significant enough, a *Daubert* challenge may be a viable option. (See "What's a *Daubert* challenge?" at left.)

Valuation process. Determining whether an expert followed all the steps required to value the business is key. For example, ask whether he or she conducted a site visit and interviewed management. If not, why? Some experts may sidestep these procedures to reduce expenses. In adversarial situations, experts sometimes simply assume controlling owners will deny access to the company's facilities or personnel — and fail to ask for it.

Assumptions and limiting conditions. Most appraisal reports contain an appendix that lists all of the valuator's major assumptions and limitations. Scour this statement for any red flags, such as a scope limitation, overreliance on management-prepared spreadsheets, or the expert's (or valuation firm's) ongoing financial interest in the client's business.

Get the most from your expert

A few key questions can help you assess a valuation expert's qualifications. Doing so will enable you to get the most from your appraiser and hold the opposing expert to account, thus avoiding costly mistakes. ●

Impairment test makeover

Requirements for testing goodwill are revised

This past September, the Financial Accounting Standards Board (FASB) revised the requirements for testing goodwill impairment for public and private entities. Because the new qualitative pretest is optional, managers and directors may wonder if they still need an outside appraiser to gauge impairment.

To minimize the use of subjective estimates and maximize the ability to audit goodwill and other intangibles, many are staying the course — especially in light of ongoing economic uncertainty.

Impairment refresher

When a business reports acquired goodwill and other indefinite-lived intangibles on its balance sheet, the

business must be tested at least annually for impairment under FASB Topic 350, *Intangibles — Goodwill and Other*. Impairment occurs when the book (or carrying) value of an asset exceeds its fair value. Testing for impairment is a two-step process. First, the business (or reporting unit, if multiple lines exist) is valued. If the company's fair value exceeds its book value, no impairment has occurred and testing stops.

If the company's book value exceeds its fair value, however, step 2 is the allocation of value to all identifiable assets and liabilities. Any remaining fair value is assigned to goodwill. Goodwill impairment equals the difference between the fair value and the book value of goodwill.

Impairment reduces the amount reported as an asset on the balance sheet and generates a loss on the income statement. These losses can't be recovered in future periods, even if value recovers.

New qualitative pretest

Many private businesses have argued that quantitative impairment testing is time-consuming and costly, especially if they operate multiple lines of business. Unlike their publicly traded counterparts, private businesses can't use market capitalizations to estimate fair value. Instead, they must hire outside appraisers.

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FASB recently issued Accounting Standards Update (ASU) No. 2011-08 to simplify impairment testing. The update introduces a qualitative pretest to assess whether it is "more likely than not" that the fair value of the company or reporting unit is less than its book value. If not, no further testing is required. But if

impairment is more than 50% likely, the company must proceed with the quantitative impairment test.

ASU 2011-08 provides a wide range of events and circumstances that an entity should consider when performing its qualitative pretest. Examples include:

- Macroeconomic conditions — such as access to capital constraints and foreign exchange rate volatility,
- Industry trends — such as raw materials and labor cost increases, and
- Company-specific events — such as declining cash flows or changes in key personnel.

FASB's list isn't all-inclusive, and none of the scenarios, in isolation, represent a reason to proceed with quantitative impairment testing. Companies also must consider positive mitigating events that may affect their qualitative assessments.

Challenges and uncertainty

Most businesses and accountants are familiar with the two-step quantitative impairment test. The new qualitative pretest introduces an element of uncertainty to reporting goodwill and other intangibles.

It also increases the role of management discretion and judgment in determining whether impairment has occurred. Often management refrains from reporting impairment because they hope that performance

will rebound and don't want to prematurely alarm stakeholders.

Auditors likely will be skeptical of internal qualitative assessments, which may increase audit fees and delay audit completion.

Outside validation

Don't be surprised if auditors ask for an outside opinion on goodwill impairment. A valuation professional can guide a qualitative pretest using a robust formalized impairment testing approach.

Or if events and circumstances are marginal, a formal appraisal can eliminate the guesswork brought on by the qualitative assessment. Although the new rule is effective for fiscal years beginning after Dec. 15, 2011, an entity may choose to bypass the qualitative assessment and proceed directly to the old quantitative assessment.

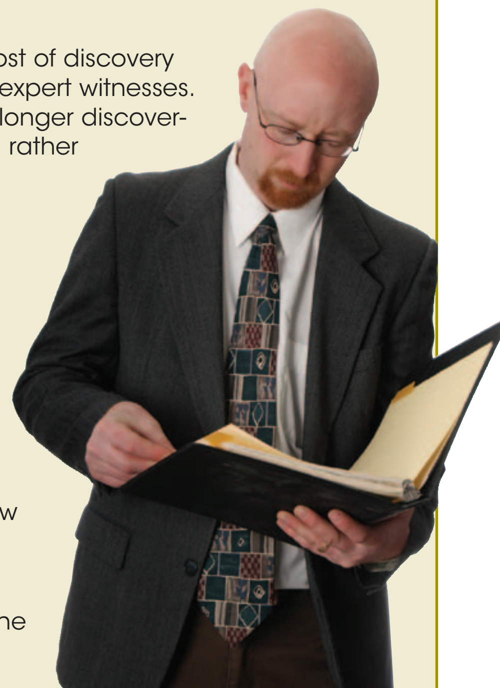
Are draft reports discoverable?

Federal courts have loosened the restrictions on the discoverability of draft reports. But don't be lulled into complacency. Many exceptions exist, so it's prudent to remain cautious when exchanging documents with expert witnesses.

In 1993, Congress revised Federal Rule of Civil Procedure (FRCP) 26 to allow discovery of all communications between attorneys and testifying expert witnesses, including draft reports. The purpose was to provide a paper trail for regulators when attorneys pressured experts to modify their opinions to better serve their clients' interests.

The result was that some experts and attorneys began to limit record retention and refrain from gratuitous note-taking. If an expert created a document that could be detrimental to a case, a new expert often was hired to ensure clean workpaper files. This added to the cost of litigation and distracted experts from the merits of cases.

Effective Dec. 1, 2010, FRCP 26 has been revamped to reduce the cost of discovery and facilitate freer exchange of information between attorneys and expert witnesses. Expert-attorney communications — including draft reports — are no longer discoverable in federal courts. Draft reports are considered a work-in-process rather than a final work product.



Now expert-attorney communications generally are subject to work-product protection, but there are some exceptions. Attorney-expert communications still open to discovery include written documents about expert witness compensation, as well as any facts, data or assumptions the attorney supplied that provided the basis for the expert's opinion.

Moreover, the exemption of draft reports only applies in federal courts. It also applies to discovery, not to admissibility, during trial. And state and district courts aren't mandated to adopt the modified version of FRCP 26. The Tax Court hasn't adopted the new rule yet, either.

Clearly, sharing draft reports and other documents is no longer taboo. But prudent experts and attorneys understand the limits of the new-and-improved Rule 26.

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