

Valuation Vantage[®]

Insights and Perspectives on Leading Corporate Finance Valuation Issues[®]

Summer 2009

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The McLean Group's Valuation Practice

As a core competency and complement to its mergers & acquisitions (M&A) practice, The McLean Group provides business valuation services, including intangible asset and financial security valuations for a variety of transactions, financial reporting and tax purposes.

Management's Forecast, The Business World's Tequila - Should it be Taken with a Grain of Salt?

With the movement to Fair Value accounting and the increasing importance of business valuation techniques throughout a company's financial statements, a discounted cash flow analysis is typically an integral part of any business valuation analysis. Market-based approaches are important and can provide useful indications of value. However, market-based approaches are limited based on the comparability of the companies, as well as the availability of financial information since they are often private transactions. Often times, valuations are based on a Company's discounted cash flow analysis, thereby making management's forecast a key assumption.

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3 Methods of Accounting for Stock Options in Business Valuations

With an increase in companies granting stock options to employees as compensation, valuation analysts are often faced with the challenge of how to account for stock options when performing a business valuation. The three most widely used methods of accounting for stock options are:

- The Fully Diluted Method

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Different Treatment for Debt & Equity Transaction Costs under SFAS 141R

Under the old SFAS 141, acquisition related costs incurred in connection with a business combination, such as finder's fees, advisory, accounting, legal, valuation, and other professional fees, were included as part of the cost of the acquired business. Now, under the new SFAS 141R, acquisition

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“Management’s Forecast...” continued from p. 1

The process of developing a forecast for a particular entity can vary significantly depending upon the Company’s industry, size, management structure, and/or customer base. These factors, as well as the amount of time and resources dedicated to preparing a forecast, can severely impact the overall analysis. Business valuers need to analyze management’s forecast. When kicking off the process, there are a couple areas that appraisers should focus on:

Understanding the Process – First it is necessary to understand the valuation process. Typically, the greater amount of time and personnel dedicated to the forecast planning process, the more detailed, and accurate the forecast will be. Who was involved in the process - executive management, accounting department, finance department, suppliers, customers? How much time was spent on the forecasting process and how often is it updated?

Management’s Track Record – It also helps to consider the Company’s track record in meeting its forecast. Historical performance will never exactly match the expected future performance, but it can serve as a helpful benchmark to illustrate management’s ability to forecast and to determine if their forecast may be too aggressive or conservative.

Identify and Analyze Key Value Drivers – It is also important to understand the fundamental assumptions that drive the forecast. Does the firm have new proprietary technology that’s expected to result in significant revenue or profitability? Has management brought in a new business development team that is expected to bolster the Company’s existing customer base? Is the forecast based on assumptions of price increases? What are the key drivers of the forecast, such as market share and proposal win rates, etc.?

Compare Performance to Industry – Understanding industry expectations can also be a valuable benchmark to validate or identify soft spots in a Company’s forecast. By comparing the subject Company’s historical performance and expected industry performance, one can start to analyze the reasonableness of management’s targets.

Listed above are a few of the steps that can help assess the reasonableness of management’s forecast. Forecast analysis plays an influential role in assisting the appraiser with his or her discounted cash flow analysis, especially with quantifying forecast risk for the purposes of estimating an appropriate discount rate. In a perfect world, management’s forecast would be taken at face value and all of its projected targets and assumptions, from the balance sheet to the income statement, would be met; however, this will never be the case, and management’s forecast should always be analyzed with scrutiny – and perhaps a grain of salt. ♦

“3 Methods of Accounting...” continued from p. 1

- The Treasury Stock Method
- The Option-Pricing Model

Each of these methods has pros and cons between accuracy and the ease with which the analysis is performed.

The Fully Diluted Method is the simplest of the three methods. It is calculated by dividing the total equity value by the total number of shares outstanding, as if all outstanding options were exercised today. The advantage of this method is its ease of calculation. However, the downside to this method is the potential to underestimate the Fair Value of the equity on a per share basis because of the cash proceeds, or inflow to the firm from the exercising of those options, are not included.

The Treasury Stock Method is similar to that of the Fully Diluted Method except it includes the cash proceeds from the exercising of options. This is done by adding the expected cash proceeds to the total equity value of the company. It is important to ensure that only the “in-the-money” options are included in the analysis. An option is “in-the-money” when the strike price of the option is less than the value of the underlying stock.

Another common approach to account for stock options is to separately value them using an Option-Pricing Model. Under this method, all outstanding options are valued using the Black-Scholes equation or other calculation method. The resulting value is then subtracted from the total equity value before being divided by the total shares outstanding (excluding options). ♦

“Different Treatment for...” continued from p. 1

related costs are not considered part of the fair value exchanged between the buyer and the seller for the acquired business and, therefore, are expensed as incurred. However, this can be misleading because the treatment of the cost of issuing debt or equity securities as part of a transaction is different.

Note that the costs of issuing debt and equity securities are not considered transaction costs of an acquisition. Generally, debt issuance costs are capitalized as an asset and amortized over the term of the debt, while equity issuance costs are deducted from the proceeds of the issuance. This means that companies using debt to finance a transaction will report lower earnings in the period of the issuance and the period the transaction closes. Companies issuing new equity will deduct the cost of issuance from the total proceeds of the issuance. Since these costs are not capitalized, this will result in less goodwill being recognized in the transaction. ♦

Spotlight on Court Cases



Gaskill v. Robbins

February 19, 2009

In this case, the Court concluded that personal goodwill of the wife's dental practice should not be included for the purposes of calculating the value of the marital asset. The Court found that there was not much reason to believe "that the skill, personality, work ethic, reputation, and relationships developed by Gaskill are hers alone and [could not] be sold to a subsequent practitioner." Also, the Court ruled against averaging values from four different methods since there was no reasonable basis for averaging the values. For purposes of calculating the fair market value, the Court overturned the trial court's argument that a non-compete agreement should be factored into the valuation of the dental practice since it in effect would reflect "a speculative item" unless it is already part of the business. ♦



Zink v. Zink

February 27, 2009

In this case, where marital assets were being valued, the wife argued that the fair market value of the husband's interest in a closely-held corporation should be much higher since there was a salary increase compared to what the husband earned prior to the employment contract to work for the Company. However, the Court ruled that the husband's 25% interest could not be sold to just anyone. Also, the husband and the majority shareholder had disputes prior to the husband being terminated and bought out as well as negotiated exit from the Company. As a result, the Court ruled that although the employment contract called for a higher salary for the husband, the future value of the salary increase beyond the date of termination was not to be included in the fair market value of the husband's interest. As a result, the amount given in the buyout was considered by the Court to be at fair market value. ♦



Menard v. Commissioner

March 10, 2009

When the CEO of the third largest home improvement store in the US, Menard's, posted a salary and bonus equaling ten times more than that of the CEO of the largest home improvement store (Home Depot), the IRS stepped in. Menard's significant bonus (\$17.5M) was calculated at year's end by adding 5% of company earnings (before taxes).

The court decided that anything above \$7.1M for Menard's CEO was excessive, using a unique formula that took into consideration Home Depot's return on investment divided by the CEO's salary, then dividing Menard's return on investment by the result of Home Depot's and finally multiplying the result by the ratio of the compensation of Lowe's CEO (second largest home improvement store) to that of Home Depot's.

Upon appeal, the Seventh Circuit Court reviewed the case. The court declared that the Tax Court committed an error, citing that the court did not take into consideration the menial amount the CEO would have been paid should the company have lost money that year. Additionally, it was proven that the CEO took on more responsibilities that were allocated to the Board of Directors and other corporate officers at Home Depot and Lowe's. Additionally, the Tax Court failed to consider severance packages, retirement plans and financial perks that the CEOs received. The Seventh Court subsequently reversed the Tax Court's decision. ♦



Valuation Practice News



Chairman of The McLean Group, Dennis Roberts' book *Mergers & Acquisitions: An Insider's Guide to the Purchase and Sale of Middle Market Business Interests* was designed not only for owners and managers of middle market businesses, but as a training text for middle market M&A investment bankers and advisors. The book is also available amazon.com.



This past semester, Andy Smith was asked to be an Adjunct Professor at George Mason University. Smith taught a class on business valuation for the MBA Program at the school.



Washington SmartCEO magazine named Andy Smith one of the SmartCPA winners for 2009. Smith will be recognized in Septemeber issue of the magazine.



On August 11th, Brian Sullivan was a guest speaker at the Hongkong and Shanghai Banking Corporation (HSBC) Community Education Series Seminar titled "The Middle Market M&A Landscape in a Troubled Economy" in San Mateo, California.

The McLean Valuation Services Group Offices

The McLean Group is a national middle market investment bank providing mergers & acquisitions (M&A), capital formation, market intelligence, business valuation, litigation support and exit planning services in over 25 offices in the U.S. and Canada. The McLean Valuation Services Group is an affiliate of The McLean Group and performs business valuation services for transaction, financial reporting, and tax purposes. The McLean Valuation Services Group has dedicated business valuation offices in the following locations:

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