

# Business Valuation Notes

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Volume 6, Issue 12

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December 2006

## Important Financial Tool...

### XBRL GETS BIG PUSH

#### MBVG Will Use for Portfolio Valuation ...

A November 8, 2006 meeting of the Global Public Policy Symposium in Paris, France, advanced the call for adoption of XBRL by companies for financial reporting and renewed the arguments for the functionality of using this means of financial reporting, stressing the importance of flexible data manipulation for business management and analysis. The GPPS position is contained in a paper published after the conference.

MBVG Principal Rawley Thomas believes that this is further testimony of the increasing importance of XBRL in modern financial reporting. "XBRL has already gained a decisive foothold in the Securities and Exchange Commission and NASD," Thomas said. "With the acceptance of Microsoft solutions now being accepted worldwide and with EDGAR moving to require public company reporting using XBRL, our job of analyzing company information should become faster, easier, and cheaper," Thomas added.



Thomas

Entitled "Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks," the document envisions investors having

access to real time company financial information through XBRL, financial statements that go beyond reporting past performance to projecting future performance based on information about business intangibles that are not currently measured, and a recommendation that companies choose to supplement regular audits with periodic forensic audits. (The document may be viewed at <http://www.GlobalPublicPolicySymposium.com>.)

MBVG has previously published articles about XBRL and its potential importance for both business managers and investors. XBRL is an acronym for eXtensible Business Reporting Language, part of a family of XML languages which are becoming a standard means of communicating information between businesses on the Internet.

One of several new products being launched by the Minnesota Business Valuation Group is a proprietary system for valuing hedge fund portfolios for annual compliance reporting. That product incorporates leading edge valuation software developed by Life Cycle Returns, of which Thomas is President; Business ValueXpress, led by Mike Adhikari; and the Abbott Index, developed by Ashok Abbott. The combined software system is capable of providing an economic means of valuing

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### NEW AUDITING REQUIREMENT MAY INCREASE COSTS COMPRESS WORK SCHEDULE

Effective this month (after December 15) Statement of Auditing Standard 103 becomes effective. The statement establishes new standards for documenting their work during audits for private companies.

Randall Schostag, MBVG President, believes that the changes, which have received little publicity and are generally little known by private company chief financial officers and company advisors, could have a significant impact on business valuations.

"The changes were brought to our attention by Mr. Denny Schleper," Schostag said. Schleper, a Certified Public Accountant and Executive Principal of Larson Allen Weishair & Co., LLP, contacted Schostag with regard to timing issues of issuing reports to LarsonAllen for Employee Stock Ownership Plans (ESOP) during 2007 for the fiscal year ending December 31.

"Mr. Schleper noted that the report of the valuation must be delivered simultaneous to the date of the CPA firm completing their audit," Schostag said. "Until now the appraiser has generally waited for the audit work to be completed so that the appraiser

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# AUDIT

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could use the CPA's draft to input the current year financial information into worksheets to obtain a value. The change means that somehow the appraiser must now obtain information before the audit is completed."

The change will require client companies to provide MBVG with financial statements which will need few if any changes by the auditor. For companies with significant year-end adjustments, the internal company staff must become proficient at making the adjustments before the audit team arrives. Without those changes, the final audit will potentially offer a very different financial picture and result in year-end financial statements which will produce a different value for the firm.

"According to Schleper, if a report is issued later than the accounting firm's report date, the CPA must go back to the company and update the investigation to the new date. This will require more work by the accountant which in turn will accrue more accounting charges for the audit," Schostag said.

SAS 103 provides both the standards and guidance for auditors to follow when documenting their work. This supersedes SAS 96, Audit Documentation, AICPA, Professional Standards and amends SAS 1, Codification of Auditing Standards.

Schostag emphasized that the standard is applicable only in those instances where the valuation will be used by the accountant for audit purposes and does not effect valuations for non audit applications. "This new statement will have the effect of really pushing the company's accounting staff," Schostag said. "For those firms who rely heavily on the accountant making substantial fiscal year-end adjustments to their financial statements, we think that this

new requirement may increase the firm's accounting fees. The accounting firm will use the concluding day of the audit as their report date. If the appraiser has not received a solid set of financial statements prior to that date, it is going to be unlikely that the appraiser will be able to issue a final opinion of value until a later date. If Schleper has correctly interpreted the new statement, that means that if the valuation report date is later than the CPA's report date, then the accountant will be required to return to the company to audit subsequent events."



Schostag said that he is puzzled by the new statement in as much as valuation reports are provided with an 'as of' date. "The effective date of a valuation means that the appraiser has offered his or her opinion of value, incorporating information only known or which could have been known as of that date. In other words, even though the valuation report date is subsequent to the report audit date, the appraiser's opinion of value precedes the report audit date. This seems to be an instance of accounting oversight failing to appreciate what 'effective date' means."

"The rationale for the revised audit standards seems well intentioned in that the accountants must ensure that they have documentation in hand before issuing a report. But I suspect in this case the statement has focused on form over substance."

Schostag said that in addition to the extra work for in-house accountants and external auditors, the new requirements are going to create timing issues for appraisers.

# TAX COURT REJECTS TAX-AFFECTING; RULES A GIFT

In late September the United States Tax Court rejected a client valuation which tax-affected earnings and also concluded that the transaction was a 'bargain sale' or 'gift' rather than a sale, as asserted by the tax payer. The ruling was obtained in Dallas v. Commissioner, TC Memo 2006-212, on September 28, 2006.

The tax payer had sold non-voting shares of Dallas Group of America, Inc. to his sons in 1999 and 2000. Consideration was cash and notes receivable. The notes were self-canceling upon the death of tax payer. The tax court said intrafamily transfers are presumed to be gifts unless evidence can be presented to show it to be a sale. The court stated that the share adjustments contained clauses which showed that the transfers were for estate planning and were not arm's-length.

The tax payer had used two appraisers. Both had tax-affected the earnings, a subchapter S corporation. The first appraiser applied a 40% tax rate while the second applied a 35% rate. The tax-affecting stemmed from the expectation that the company would lose its S status on sale.

The tax court concluded that there was insufficient evidence a hypothetical buyer and seller would tax affect the earnings and determined that it was, therefore, inappropriate to tax-affect in this valuation.

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# XBRL PUSH

(Continued from page 1)

multiple securities in a portfolio with a robust and defensible process, but it requires many financial inputs which would reduce the cost effectiveness if all of the information had to be input manually.

MBVG expects to launch the software in January 2007. Thomas said that the launch is about two months behind schedule due to additional work to ensure that the system has capability to value private firms as well as publicly held securities.

“Hedge funds today have been investing many funds into privately-held securities,” Thomas said. “MBVG has extensive experience in appraising private companies, and we have incorporated that experience in our system. Frankly it has taken longer than we anticipated, but the resulting product should make us the leader in portfolio compliance software. It has been developed keeping in mind the extensive body of law which already exists with respect to valuation whereas we don’t think that our competitors in this area have paid much attention to that aspect,” Thomas added.

Michael Choniski, an MBVG Affiliate, said, “This market is just emerging, and we think that all funds, not just hedge funds, will eventually be required to provide independent reviews of their portfolios. The fact that we can include privately-held securities significantly differentiates us from others who want to be in this space. However, including private companies also increases the need to transfer financial information into our system, and that increases the importance of XBRL.”



**Choniski**

XBRL is being developed by an international non-profit consortium of approximately 450 major companies,

organizations, and government agencies. The GPPS position is not new but serves to remind the business and investment communities that the push to use XBRL, which is now several years old, has been gathering substantial support by both domestic and international sponsors. XBRL International Inc., the nonprofit business consortium which also includes the AICPA first introduced the language in 1999. (See <http://www.XBRL.Org>.)

GPPS’s vision states “the same forces that are reshaping economies at all levels are driving the need to transform what kind of information various stakeholders want from companies, in what form, and at what frequency. In a world of ‘mass customization’, standard financial statements have less and less meaning and relevance.”

According to AccountingWEB. in a letter to the Wall Street Journal published on November 8, the day their paper was released, the CEOs wrote that when the basics of current accounting procedures were written, the world’s investors were more a “private club than a global network. Auditors used fountain pens, capital stayed pooled in a few financial centers, and information moved by runner.” The world has changed since then. In the short term, the letter says, it will be necessary to proceed as rapidly as possible with convergence in international accounting standards, and with overcoming national differences in oversight of auditors and in enforcement.

The Journal letter notes that in the future auditors will have an increased responsibility to evaluate the usefulness to investors of information provided in the current financial statement and footnote format and consider the inclusion of more nonfinancial information. But, the CEOs say in the Journal letter, “All of these steps should include an emphasis on allowing auditors greater room to exercise judgment. Accountants and auditors are trained professionals who have the ability to apply the spirit of broad principles in deciding how to account for and report financial and other information. Such [future] measures should also include an honest assessment of the “expectations

gap,” relating to material fraud and the ability of auditors to uncover it at a reasonable cost.”

The paper looks forward to a world “where users increasingly will want to customize the information they receive” in which “the process for recording and classifying business information will be as important, if not more important, than the static formats in which today’s financial information is reported.”

There will be an increasing focus on business processes, the paper states, and that XBRL users shortly will be able to view company data in any language, any currency and under different accounting systems and get immediate answers to queries.

At this time approximately 40,000 companies already use XBRL to input their data. China, Spain, the Netherlands and the United Kingdom have required companies to use XBRL.

## STOCK OPTION VALUATION RISES IN IMPORTANCE

In September, the National Center for Employee Ownership solicited input as part of a study on the perceived value of employee stock options. The call for participation was made following a recent university research report reported that executives dramatically undervalue (by 50% on average) their employee stock options relative to the Black-Scholes value of those options. The research said that this “cost-value gap” was generally eliminated by providing executives with personalized education on the time value of their stock option holdings.

The National Center for Employee Ownership (NCEO) is a private, nonprofit membership and research organization that serves as a source of accurate, unbiased information on employee stock ownership plans (ESOPs), equity compensation plans such as stock options, and ownership culture.

(Continued on page 5—Stock Options)

# MBVG DENTAL EXPERTISE

Dr. Stanley Pollock, DMD, PHD, JD, MCBA, recently completed a new section for "The Market Approach to Valuing Dental Practices" for the 2006 2007 Supplement in *Valuing Professional Practices and Licenses, A Guide for the Matrimonial Practitioner (Third Edition)*. Edited by Ronal L. Brown (Aspen Publishers), the supplemented should be distributed by mid January, 2007.

Pollock is an Affiliate of the Minnesota Business Valuation Group. Within MBVG he specializes in supporting the group for dental and other healthcare appraisals and for an increased understanding among appraisers to appreciate the difference between conventional businesses and professional practices.

"Professional practice appraisal can differ significantly from valuing other forms of business," Pollock said. "The appraiser, for example, must learn to understand how much value is due to the professional personally and how much value can be attributed to the practice without the practitioner."

"Years ago," Pollock said, "practices were valued at 100% of the latest annual gross revenues. At that time, the average overhead of a general dental practice was running around or less than 50%. Dental practices seldom changed hands and the most experienced was the secondhand man who told the dentist or widow how much he would pay for the equipment and furniture as he carted it away."

Today the valuation of dental practices as well as other professional practices has become much more complex and encompasses the valuation of both tangible and intangible assets and goodwill. There is a decisive difference determined by the practice specialty, its location, and its size. To value a

dental practice the analyst must assess the earnings generated beyond its return on these assets as well as compare the practice value to prices obtained in free market transactions. Pollock has been particularly instrumental in providing the national valuation community with transaction data for dental practices sold so as to offer a means for ascertaining what values have been realized in actual business sales.

Pollock gives substantial credit for development of the database to Raymond Miles, a cofounder of the Institute of Business Appraisers in Florida and a leading business appraisal accreditation firm for valuation analysts. Miles recognized the need to gather and organize market data for appraisals of small businesses and professions. He thereafter developed and copyrighted the Direct Market Data Method (DMDM) which continues to be used by appraisers across the United States.

The Appraisal Standards Board, formed in 1989, required that "an appraiser must consider all appropriate methods and procedures in developing a business or intangible asset appraisal", Pollock said. The Internal Revenue Service in 1959 also had issued Revenue Ruling 59-60 which sets forth requirements of appraisals for tax purposes and which prefers the use of market data.

Although the IBA database for use with DMDM has been very successful in acquiring private company transaction information for use by appraisers, perhaps no single industry in IBA's list of private industries has as much data as that contained within its dental industry database. While many of the industries offer only a dozen or less transactions, the dental database has more than 1,200 transactions for dental practices. Ray Miles of IBA has credited Pollock with the reason why IBA has been so successful in obtaining so much information for this industry niche.

Use of the IBA database

differs from most of the other market approaches in as much as it provides market insight rather than a comparison of businesses or practices. "While other methods are based on comparisons about practices," Pollock said, "the DMDM is about markets."

The supplement to *Valuing Professional Practices and Licenses, A Guide for the Matrimonial Practitioner* is expected to be delivered to subscribers by mid January 2007. Aspen Publishers, which is located in New York.

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## STOCK OPTIONS

*(Continued from page 3)*

The Minnesota Business Valuation Group has often commented on the changes which have been occurring in the accounting community with respect to options. Changes include Statement of Financial Accounting Standard 123(R), which pertains to expensing stock options for accounting, and Section 409(A) of the Internal Revenue Code, which pertains to deferred compensation arrangements. MBVG President Randall Schostag noted, "These changes have increased the importance for company executives to be more careful when assigning a value to options issued for both employees and non employees."

The study referred to by NCEO is entitled *Employees' Perceived Value of Their Stock Option Holdings: How Training Affects the Cost-Value Gap*. The paper was a collaboration of two assistant professors at the University of Illinois at Urbana-Champaign and an associate professor at Michigan State University. The paper is dated May 30, 2006. The data used for the study was obtained by the researchers under a confidentiality agreement with Net Worth Strategies, which provides equity compensation planning services provided during the period from September 2004 through March 2006.

Although not yet subjected to peer review, the study states that before training the majority of employee stock option recipients in the sample or 75% perceive the forfeit value of their stock options to be less than the cost. The median ratio of the forfeit value to cost was 0.396. This is both a statistically significant discount and an economically significant discount. The same study

states that 78% of stock plan professionals (consultants and plan administrators) also underestimate stock option value for a hypothetical employee relative to a Black-Scholes cost.

The researchers noted that although the results varied across participating firms, the majority of the recipients in each firm initially discounted their perceived forfeit value to cost. After training, according to the study, there was no longer significant evidence of a median discount in the recipients' perceived forfeit values relative to cost. Supplemental evidence provided mixed evidence that risk aversion decreases perceived value, and that wealth concentration and prior stock option experience increased perceived value.

"Importantly, we find that a training program which clearly articulates the economic fair value of recipients' options increases both their perceived value and their confidence in related decision-making," an abstract of the paper states.

The Minnesota Business Valuation Group provides valuation services for Employee Stock Ownership Plans (ESOP) and also valuation support for stock option valuation, particularly when required by accountants for audit purposes such as for expensing and for deferred compensation programs. Over the last 20 years stock option programs have become a popular mechanism along with both qualified and nonqualified common stock programs for companies to both compensate their employees and at the same time to incent them to make the company the more successful.

Schostag noted that in the case of ESOPs, which are qualified common stock plans, the employees have had the advantage of an annual valuation, giving them the ability to track their progress. This has been regulated by the Department of Labor which has set forth some very strict rules about ESOP disclosure. Although the use of employee stock options has been growing, practitioners have been questioning the incentive benefits of this form of compensation because employees' have not had the ability or disclosure to appropriately value their options.

"We've seen this in the case of ESOPs," Schostag said. "At some time all of our clients with ESOPs have struggled to educate their employees about the value of their ESOP, thus ensuring the intended goal of incenting the employees to work harder." A survey by PriceWaterhouseCoopers (2005) has found that employee communications regarding equity plans is one of the most challenging aspects (behind compliance and administration) of offering equity compensation.

Since companies must now expense options based on Black-Scholes or another approved valuation method, the NCEO said, the existence of a cost-value gap raises important questions regarding the viability and effectiveness of stock option programs in fulfilling their stated purpose of motivating and retaining key employees.

The adoption of both SFAS 123(R) and IRS Code Section 409(A) has increased the cost of not correctly valuing the options as well. If a deferred compensation arrangement is subject to 409(A) and fails to comply with the new rules, there is a possible double punch. First, any amount deferred will be taxable in the year it was initially deferred, and second, the amount will be subject to an additional 20% tax, plus interest. All of these penalties are paid by the individual receiving the compensation rather than by the company paying the compensation.

"I certainly wouldn't want to be the human resources person or the chief financial officer of a company who had to give that news to the employee," Schostag said.

The list of deferred compensation arrangements subject to 409(A) is long, and includes: discounted stock options, elective deferred compensation, non-elective deferred compensation, stock appreciation rights, phantom stock, restricted stock units, certain guaranteed severance arrangements, and other promises to pay compensation in the future.

# Minnesota Business Valuation Group

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#### **BUSINESS VALUATION**

Goodwill Impairment Analysis (141/142)

Businesses

Intellectual Property

Intangible Assets

Options

Strategic Planning

ESOP

Divorce

Shareholder Oppression / Dissenting Rights

Buy/Sell Agreements

Merger / Acquisitions

Fairness Opinions /Purchase Allocation

Planning

#### **BUSINESS ASSET VALUATION**

Experts or Consultants

Sale / Purchase

Insurance

Fair Rental Rates

Financing

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Condemnation

Feasibility

Purchase Price Allocation

Property Records

Fiduciary Review

Sale / Leaseback Structuring

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