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MERCER CAPITAL'S LATEST THINKING

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Tax Court Upholds Daubert Challenge to Appraisal Expert

New Valuation Blog!

VALUATION SPEAK
A DISCUSSION MODERATED BY CHRIS MERCER

ValuationSpeak is a new blog authored by Mercer Capital's CEO Chris Mercer. Chris introduces the blog:

ValuationSpeak.com is my new blog. After a four-year hiatus, I have returned to blogging with a new look and a new focus. This blog is about valuation - and value. There have been over 50 posts on ValuationSpeak.com since I started in January of this year. The following categories have been most prominent to date:

» **Statutory Fair Value.** Statutory fair value is an area of personal interest and one that has been virtually ignored by business valuation writers. The series on statutory fair value now includes over 15 posts and is rising. We are exploring statutory fair value in the context of an integrated theory of business valuation, and are developing an ability to discuss judicial decisions in a consistent and coherent manner.

» **Buy-Sell Agreements.** It should come as no surprise that buy-sell agreements is a topic. Help me get the message out to all business owners that their buy-sell agreements are very important documents and that virtually all of them are ignored by the persons most likely to be affected when they are triggered.

» **Literature Review.** Nine posts so far have focused on books or articles of interest.

» **Valuation Theory.** There is duplication here with the statutory fair value series, but over ten posts in this category address significant valuation issues.

We will continue with these focus areas and develop others as time allows and circumstances dictate.

Because you are reading this newsletter, which is sent to clients, business owners, accountants, attorneys, financial planners and other business advisers, then you are the target market for ValuationSpeak.com.

I hope you will read the blog, subscribe via RSS reader or email notifications, and comment.

Z. Christopher Mercer, ASA, CFA, ABAR

Check the blog out at www.ValuationSpeak.com

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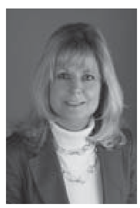

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Focus On | Tax Compliance Valuation

Tax Court Upholds Daubert Challenge to Appraisal Expert

by Jean E. Harris, CFA

In April 2011, the Tax Court decided in favor of the IRS in a conservation easement donation case. In *Boltar, L.L.C. v Commissioner*, 136 T.C. 14 (April 5, 2011) a *Daubert* challenge to petitioner's expert was upheld due in part to the advocacy of the expert for his client.

Overview of the Case

In a conservation easement donation case, the IRS moved to exclude the taxpayer's experts' report as unreliable and irrelevant under Federal Rule of Evidence 702 and *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579 (1993). The Court held that taxpayer's experts failed to apply the correct legal standard by failing to determine the value of the donated easement by the before and after valuation method, failed to value contiguous parcels owned by a partnership, and assumed development that was not feasible on the subject property. The IRS's motion to exclude Petitioner's report and expert testimony was granted.

Facts of the Case

Two parcels (Northern Parcel and Southern Parcel) of approximately 10 acres each were acquired in 1999. In 2002, the Shirley Heinze Land Trust, Inc. ("Shirley Heinze") quitclaimed 10 acres located east of the Southern Parcel ("the Eastern Parcel") to Boltar.

At the date of the subject easement the Southern Parcel was encumbered by a 50 foot wide utility easement and the Northern and Southern Parcels were encumbered by an access (golf cart) easement. On December 29, 2003 an easement ("Subject Easement") restricting the use of eight acres on the eastern side of the Southern Parcel was granted to Shirley Heinze.

The Subject Easement prevented any use of the property that would significantly impair or interfere with the conservation values of the property. Approximately three acres of the subject easement, 9 acres of the eastern portion of the Northern Parcel, and all of the Eastern Parcel are forested wetlands.

At the valuation date, the Northern and Southern parcels were zoned R-1 (one single family home per acre). The Eastern Parcel was zoned as a Planned Unit Development (PUD) as part of a three phase proposed development.

Boltar claimed a charitable contribution of $3,245,000 related to the Subject Easement. The fair market value of the easement was reported as $3,270,000 and was reduced by $25,000 as a claimed enhancement in value to adjacent parcels owned by Boltar.

The real estate appraisal ("Taxpayer Appraisal") attached to Boltar's 2003 tax return determined that the highest and best use of the subject property was residential development and determined the easement value as the difference between the "Foregone Development Opportunity of 174 Condominiums on Finished Sites, Discounted to December 31, 2003" (Scenario B) $3,340,000 less the "Value of Raw Vacant and Developable Land" (Scenario A) $68,000. The Taxpayer Appraisal relied on a site plan for a condominium project situated on approximately 10 acres and erroneously assumed the subject easement was zoned PUD.

In the final partnership administrative adjustment (FPAA), one of the IRS's valuation engineers determined the fair market value of the Subject Easement was $42,400. The engineer opined that the Taxpayer Appraisal failed to determine the value of the Subject Easement before and after the grant of the easement. The engineer concluded that the highest and best use of the subject property was for "development of single-family detached residential homes, but not until the surrounding properties are developed", partly because the subject easement was landlocked with no direct access to a public road.

Opinion

The Court quoted IRS Regulations Section 1.170A-14(h)(3)(i):

> The value of the contribution under section 170 in the case of a charitable contribution of a perpetual conservation restriction is the fair market value of the perpetual conservation restriction at the time of the contribution. ... If no substantial record of market-place sales is available to use as a meaningful or valid comparison, as a general rule (but not necessarily in all cases) the fair market value of a perpetual conservation restriction is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction.

The Court commented that "while there may be cases in which the before and after methodology is neither feasible nor appropriate, petitioner has not provided any persuasive reason for not applying it in this case."

The Court then commented that "In the context of this case, the task of the appraisers was to determine the fair market value of the eight acre parcel and the contiguous parcels owned by Boltar before and after the easement was granted." The opinion went on to say:

> Petitioner quotes this Court's cases, *Symington v. Commissioner*, 87 T.C. 892 (1986), *StanleyWorks & Subs. v. Commissioner,* supra, and *Hughes v. Commissioner*, T.C. Memo. 2009-94, to emphasize the necessity of considering highest and best use by determining "realistic" or "objective potential uses", to which the subject property is "adaptable" and which are "reasonable and probable" uses. We conclude, however, that the [taxpayer] appraisal's valuations fail to apply realistic or objective assumptions.

The Taxpayer's Appraisal's highest and best use, prior to the conservation easement encumbrances, was a ten acre, 174-unit condominium development yet the Court noted "In support of the argument that the 174-unit condominium project assumed by the [taxpayer's] report could not be physically placed on the subject property, respondent points out that the site plan for the proposal assumes ten acres, whereas the subject property was only eight acres, and the [taxpayer's] experts ignored the effect of a preexisting 50-foot-wide utility easement for a gas pipeline across the property." To make matter worse, the taxpayer's experts "erroneously" concluded that the eased parcel was "within the city of Hobartand zoned PUD, which it is not."

Addressing the taxpayer's report and experts, the Court stated "Petitioner's experts, however, did not suggest any adjustments or corrections to their calculations but persisted in their position that the original appraisal was correct, even when admitting factual errors. (By contrast, respondent's experts conducted research in areas that were not within their specific expertise, acknowledged weaknesses, and corrected errors during their analysis.) Neither petitioner nor the Integra experts suggested any quantitative adjustment in response to their admitted errors or the problems addressed in respondent's motion in limine. They simply persist in asserting an unreasonable position."

The Court further noted that the Taxpayer's Appraisal of the highest and best use for its "before" value, the condominium development, resulted in a value of $400,000 per acre. However, nearby property that could also be developed into condominiums was selling for only $12,000 per acre.

According to the Court, such "factual errors" defy "reason and common sense" and "demonstrated [a] lack of sanity in their result."

Failure of the Taxpayer's Appraisal Expert and the Daubert Challenge

The IRS aptly summarized the deficiencies of the Taxpayer's Appraisal as:

- Failure to properly apply the before and after methodology, to value all of petitioner's contiguous landholdings

» Failure to take into consideration zoning restraints and density limitations
» Failure to take into consideration the pre-existing conservation easements

As a result, the [taxpayer's expert] saw nothing wrong with a hypothetical development project that could not fit on the land they purportedly valued, was not economically feasible to construct and would not be legally permissible to be built in the foreseeable future.

The IRS asserted that the Taxpayer Appraisal had departed from the legal standard to be applied in determining the highest and best use of property and instead determined a value "based on whatever use generates the largest profit, apparently without regard to whether such use is needed or likely to be needed in the reasonably foreseeable future."

Boltar argued against a *Daubert* exclusion because:

» *Daubert* applies to jury trials
» The IRS had previously accepted the methodology used in the Taxpayer Appraisal and stipulated that the version attached to the partnership return was a qualified appraisal
» Tax Court Rule 143(g) mandates receipt of the report in evidence
» The matters complained of by the IRS do not affect admissibility of the Taxpayer Appraisal into evidence

The Tax Court refuted every argument of the taxpayer against a *Daubert* exclusion. The Court concluded that the Taxpayer's Appraisal was not admissible under Rule 702, because it was not the product of reliable methods and the authors had not applied reliable principles and methods reliably to the facts of the case.

The Tax Court noted:

> In most cases, as in this one, there is no dispute about the qualifications of the appraisers. The problem is created by their willingness to use their resumes and their skills to advocate the position of the party who employs them without regard to objective and relevant facts, contrary to their professional obligations....
>
> Justice is frequently as blindfolded to symbolize impartiality, but *we need not blindly admit absurd expert opinions. [emphasis added]*
>
> After decades of warnings regarding the standards to be applied, we may fairly reject the burden on the parties and on the Court created by unreasonable, unreliable, and irrelevant expert testimony. In addition, the cottage industry of experts who function primarily in the market for tax benefits should be discouraged. Each case, of course, will involve exercise of the discretion of the trial judge to admit or exclude evidence. In this case, in the view of the trial judge, *the expert report is so far beyond the realm of usefulness that admission is inappropriate and exclusion serves salutary purposes. [emphasis added]* ...
>
> We are not inclined to guess at how their valuation should be reduced by reason of their erroneous factual assumptions. Their report as a whole is too speculative and unreliable to be useful.
>
> Although the [taxpayer's] experts determined that sales of comparable land nearby were occurring at approximately $12,000 an acre, their conclusion would assign a value of approximately $400,000 per acre to the subject property....
>
> *If the report and their testimony were admitted into evidence, we would decide that their opinions were not credible.* The assertion that the Eased Parcel had a fair market value exceeding $3.3 million on December 29, 2003, before donation of the easement, i.e., that it would attract a hypothetical purchaser and exchange hands at that price, *defies reason and common sense. [emphasis added]*

The Court concluded that the Taxpayer's Appraisal failed to apply realistic or objective assumptions, did not consider potential residential use of the property and thus did not value the property at its highest and best use after the easement was granted, and did not consider the effect on contiguous property owned by Boltar.

Valuation of the Easement

After excluding the taxpayer's appraisal and testimony, the Court found the record contained factual evidence and the report and testimony of the IRS's valuation expert. There was no credible evidence that a higher density development than single-family residential development was a use to which the property was adaptable, given the preexisting easements and existing zoning. There was no evidence that justified a value higher than the amount determined in the FPAA.

Takeaways from the Case

Quoting from L. Paul Hood, Jr., JD, LLM, and co-author (with Timothy R. Lee, ASA, of Mercer Capital) of **The Business Valuation Reviewer's Handbook** *(see page 14)* from his post "*Daubert* Challenges and the Tax Court," written from the standpoint of a user of business appraisal reports:

> Ouch! **This is a very, very important decision** and highlights the risk of trial for either party, especially where there is a wide chasm between the positions of the experts. While there are certainly two sides to every story, it certainly appears that in the opinion of the entire Tax Court, the appraisers in this case were guilty of hubris by even failing to address their own factual errors and other problems with the report except to continue to assert the correctness of their positions. What are some of the takeaway lessons from *Boltar*?
>
> » **It is critical that the appraiser be objective and reasonable**. How do you know when your appraiser is not being objective and reasonable? It requires you to be objective and reasonable as well, even when you are zealously advocating your client's position. Co-opting your appraiser into being an advocate is the absolutely wrong approach. This is one of the reasons why I believe that a trial appraiser should not also serve as a rebuttal expert. I believe that simultaneously serving in both capacities compromises the expert in the eyes of the court. I far prefer to keep my trial expert "above the fray" and suggest hiring a separate rebuttal expert where it is determined that one is needed, even though it admittedly adds to the cost. What if your appraiser's conclusion of value differs greatly from that of another qualified appraiser on the other side (and by this, I don't necessarily include the work of the IRS valuation engineers, many of whom are not qualified appraisers)? It puts the onus on you to consider the possibility of having another appraiser conduct a "review" (this is a technical valuation term of art) of the subject appraisal. On balance, reviews are suggested every time that there are large differences between the conclusions of value of qualified appraisers. True, this adds expense that the client may not go for, but it's so important in my opinion that you should go on record in writing as having suggested it so that if your appraiser is wrong, you at least can say "I told you to get a review."

(Please see the back cover for the conclusion of this article.)

For several years now, industry experts have been predicting a wave of bank consolidation. The initial reasoning was that weaker banks would be absorbed by stronger banks, many against their will when faced with the choice of merger or failure. As time passed the industry realized that even the healthiest institutions were either unwilling or unable (sometimes both) to take on the debt, shareholder dilution, and asset quality problems that come along with an acquisition.

At present, the presumed M&A driver for the near-term is regulatory changes, which will place a substantial burden on institutions. The smaller the institution, the theory goes, the more onerous the burden and the more diminished the ability to absorb the associated costs. The only solution, many argue, is to grow organically (not easily done in the current environment) or find strategic combinations that will create a bank large enough to support the additional operating expense.

Is this wave of predicted merger activity finally coming to fruition?

Bank Merger & Acquisition Review

A Look Back at 2010 and Look Forward in 2011

by Laura J. Stevens, CFA

One might think so, based on the uptick in announced bank deals in 2010. According to SNL Financial, LLC there were 205 announced deals in 2010, compared to 175 announced in 2009. This does not include the 157 FDIC-assisted transactions which occurred during the year. Additionally, deal value was substantially higher in 2010, at $11.8 billion, compared to $2.0 billion in 2009. The increase in total deal value was supported by a few larger acquisitions, including BMO's purchase of Marshall & Ilsley Corporation ($5.8 billion), Hancock Holding Company's purchase of Whitney Holding Corporation ($1.8 billion), and First Niagara Financial Group's purchase of NewAlliance Bancshares, Inc. ($1.5 billion).

However, the M&A story in 2010 lies within the realm of the community bank. As shown in Figure One, for deals in which pricing multiples and deal value are available (a total of 111 transactions), 84 transactions, or more than 75%, involved a seller with assets less than $500 million.

What is notable in Figure One is that the size of the seller appears to be negatively correlated with the pricing multiples received, particularly on a book value basis.

The smallest banks were the only group which reported a median purchase price at a premium to book value, both reported and tangible. Of course, it is worth noting that the larger groups contain a fewer number of transactions, and perhaps reflect a more dire situation on the part of the seller, who presumably has little incentive to sell in the current pricing environment.

Cash remained king in 2010 as the most common form of transaction funding. Forty of the 111 transactions reporting multiples were all-cash acquisitions, followed closely by 38 which were some mixture of cash and other consideration (generally common stock). Capital contributions accounted for eighteen of the transactions and common stock was used as currency in six of the transactions. The remainder were unclassified or not reported.

The banking industry has always exhibited a proclivity to finance acquisitions using cash on hand. However, it is no surprise that buyers, who likely are facing their own problems with low stock valuations, are reluctant to dilute shareholders by using what many consider to be an undervalued asset to fund purchases. After all, pricing multiples in the public marketplace remain well off the

Asset Target Size

	Median Asset Size	Median Price/LTM EPS	Median Price/ Book	Median Price/ TBV	Median Price/ Assets	Median Tang. Prem/ Core Dep.	No. of Trans.	% of Total Transactions
Assets < $500 Million	$113,750	22.61	110.45	114.73	12.49	3.81	84	75.7%
Assets $500 Million to $2 Billion	$910,963	21.49	89.75	99.83	10.68	4.51	18	16.2%
Assets $2 Billion to $10 Billion	$3,531,998	24.57	63.55	63.90	6.83	-2.28	5	4.5%
Assets > $10 Billion	$11,972,673	nm	65.18	98.30	7.28	-2.48	4	3.6%

FIGURE ONE

Region

	Median Asset Size	Median Price/LTM EPS	Median Price/ Book	Median Price/ TBV	Median Price/ Assets	Median Tang. Prem/ Core Dep.	No. of Trans.	% of Total Transactions
Atlantic Coast	$348,063	33.61	78.99	80.76	9.47	-0.23	15	13.5%
Midwest	$113,575	22.20	116.18	122.44	12.73	4.76	42	37.8%
Northeast	$329,637	20.79	112.59	116.70	11.51	2.57	27	24.3%
Southeast	$111,066	17.67	104.80	104.80	13.21	1.31	10	9.0%
West	$139,469	45.00	98.29	98.38	12.27	2.16	17	15.3%

FIGURE TWO

highs of 2006 and 2007, when bank stocks commonly traded at price-to-earnings multiples approaching twenty times and book value multiples as high as three times. Additionally, with the universe of transactions focused on smaller institutions, many do not have publicly traded equity, and sellers often frown on accepting illiquid stock as transaction currency.

In terms of geography, there was a distinct relationship between the economic health of various regions and the volume of transaction activity. During 2010 the concentration of FDIC-assisted transactions (i.e., bank failures) centered around states with severely disrupted real estate markets, such as Florida (29 failures), Georgia (21 failures), Illinois (16 failures), California (12 failures), and Washington (11 failures). Perhaps not surprisingly, non-assisted transaction activity was highest in regions without a high level of bank failures, as shown in Figure Two (includes only those deals reporting pricing multiples).[1]

Outlook for 2011 and Beyond

The next logical question is what will 2011 hold for bank M&A activity? While we do not have a perfectly clear crystal ball, here are a few things to consider:

» The new regulations that will come as a result of the Dodd-Frank Act, once they are written, will most likely hamper a bank's ability to generate fee-based income, which is an increasingly large portion of the bottom line for most financial institutions.

  Many industry insiders believe there is a "magic" size that a bank will need to be in order to absorb the additional costs and lower revenues inflicted by the new regulations. Whether that number is $500 million or $1 billion in assets, popular figures at the moment, or some other amount, there will be a measurable number of banks that are below the threshold.

  While some may resist the urge to merge, and indeed some will face specific circumstances that allow them to survive despite their smaller size, there is certainly an impetus for mergers of equals and for smaller institutions to begin shopping themselves to the highest bidder.

» Because of increasing regulatory burdens, we have heard from life-long bankers on a number of occasions that they simply no longer enjoy what they are doing.

  Many, who are second and third generation bankers, have entertained the idea of selling the bank in order to avoid the extreme headache which comes along with increasing regulatory oversight. While these thoughts may be dampened somewhat when it comes time to put pen to contract, and particularly in light of the current pricing environment, it is a real trend that could lead to more institutions being marketed for sale in the next several years.

» While there may be more banks for sale and more incentive to merge, financing such purchases may be easier said than done.

  Capital remains difficult to come by for financial institutions, and both market and non-market forces are responsible culprits. First, regulators are requiring a higher capital cushion from banks, a requirement with which a large portion are not in compliance at present. It will take a number of years to build up adequate capital levels, particularly given that most increases in capital will likely have to come from retained earnings as investors remain hesitant to contribute additional capital to all but the healthiest banks. Secondly, the issuance of new trust preferred securities, which previously were a relatively cheap and accessible source of capital for financial institutions, has been virtually eliminated by the Collins Amendment to the Dodd-Frank Act, which prohibits this form of capital for larger institutions and only grandfathers in existing trust preferred securities for smaller banks.

» FDIC-assisted transactions are likely to continue at a rapid clip, as the problem bank list stood at 884 for the fourth quarter of 2010, compared to 702 banks at year-end 2009 leading into a year where we saw 157 bank failures.

  For banks that are actively pursuing a strategy involving growth by acquisition, there is little incentive to pay full market price for a healthy institution when the failed banks marketed by the FDIC are available at such extensive discounts, even despite the associated bidding, asset quality, and other problems related to purchasing a failed bank.

- » While outside investors have, up to this point, been effectively shut out of the market for whole-bank purchases, the tide seems to be turning.

  A number of private equity acquirers participated in FDIC-assisted transactions in 2010, which previously had generally been frowned upon by the FDIC. Additionally, private equity firms have recently been allowed to file shelf charters which allow them to quickly form a bank holding company for purposes of acquiring an existing institution. Purchases of banks and bank holding companies must to be approved by regulators, who up to this point have shown a preference that the acquirer be another bank. An additional subset of buyers in the market can only serve to increase demand, transaction activity and, most likely, pricing multiples.

Will 2011 be the year of the bank merger? Signs remain mixed, but it appears conditions are favorable at the very least for an increase in merger activity. Then again, we have definitely heard that before.

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ENDNOTES

[1] The regions include the following states:

Atlantic Coast – DE, FL, MD, NC, SC, VA, WV, Washington, D.C.

Midwest – IA, IL, IN, KS, MI, MN, NE, ND, OH, OK, SD, TX, WI

Northeast – CT, ME, MA, NH, NJ, NY, PA, RI, VT

Southeast – AL, AR, GA, KY, LA, MO, MS, TN

West – AK, AZ, CA, CO, HI, ID, MT, NV, NM, OR, UT, WA, WY

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Is It Time to Change ESOP Appraisers?

15 Reasons Why It Might Become Necessary and How to Accomplish It

by Timothy R. Lee, ASA and Wendy S. Ingalls, CPA/ABV, CBA, ASA

ESOP valuation is an increasing concern for Trustees and sponsor companies as many ESOPs have matured financially (ESOP debt retired and shares allocated), demographically (aging participants), and strategically (achieved 100% ownership of the stock).

Given these and other evolving complexities (including the proposed DOL regulation which would designate ESOP appraisers as fiduciaries of the plans they value), it is sometimes necessary or advisable for ESOP Trustees and the Boards of ESOP companies to change their business valuation advisor.

This article addresses why a Trustee or sponsoring company might or should opt for a new appraisal provider, as well as what criteria, questions, and qualities drive the process of selecting a new appraiser.

Why a Change in Appraisers Might Become Necessary?

There are potentially many circumstances and/or motivations that can compel an ESOP Trustee to seek a new valuation advisor. We list 15 in no particular order.

1. **The current appraiser is no longer available or is unwilling to perform the annual plan year valuation.** Due to retirement, firm closure, conflict of interest, or some other reason that is beyond the control of the Trustee or sponsor company board, the legacy appraiser is not available or willing to perform annual plan year valuations.

2. **The legacy appraiser has resigned from the ESOP appraisal due to evolving regulatory decisions from the DOL.** As of the drafting of this article, the DOL has requested and considered feedback and testimony concerning the designation of ESOP appraisers as fiduciaries of those plans they value. If the proposed regulations are enacted, growing numbers of sponsoring companies may be forced to identify and retain a new appraiser because their legacy appraiser has resigned from the ESOP appraisal. This issue and its ramifications for Trustees, sponsoring companies, and ESOP appraisers warrant continued monitoring.

3. **Growth and/or evolution** in the sponsor company's business model, industry, market complexity, management, or otherwise can take a business from a once comfortable and familiar place for the appraiser to one that is beyond their resources and competencies.

4. **The maturation of the ESOP** may be creating new or increased concerns regarding the valuation or other Trustee considerations that are not being adequately addressed.

5. **The legacy appraisal product does not reflect current valuation theory, methodology, and/or reporting standards.** Trustees that suspect their valuations are lacking in thoroughness, accuracy, or reasonableness might be well-served to obtain an independent review of the work to identify problem or missing content before any decision is made to change appraisers.

6. **The sponsor company has experienced volatile or declining performance that is not quantified or otherwise addressed in the ESOP valuation.** The lack of reconciling valuation information and conclusions to market and/or financial evidence may suggest a variety of ills ranging from complacency to advocacy.

7. **The appraisal conclusions and underlying valuation components have not been reconciled with prior valuations or over time.** Trustees need to be able to examine the underlying performance, market evidence, and valuation treatments over time in order to offer constructive feedback and questions, as well as to track the investment and operating performance of the sponsor company. However, keep in mind that valuation practitioners must be allowed to enhance or augment their reports and methodology with the passage of time, the advancement of analytical treatments and approaches, the evolution of the body of knowledge, in response to draft review processes, and to comply with changes in regulations and compliance requirements.

8. **Excess control premiums have been applied to a controlling interest ESOP valuation resulting in a potentially higher than reasonable value and causing serious ramifications for participants and sponsor companies.** Over-valuation is a consistent issue in many ESOP appraisals. A principal cause of overvaluation is the direct or implicit application of unwarranted or unsupportable control premiums. Control premiums, particularly when styled as specific and finite adjustments in a valuation, are generally not advisable in the appraisal world unless they are explained and reconciled financially. If the appraiser cannot articulate the financial basis for the application of (and the magnitude of) a control premium by direct reference to earnings enhancements, risk mitigation, enhanced growth rates, or other fundamental valuation drivers and assumptions, then a Trustee would be well-served to question the appropriateness of the premium.

9. **Valuation discounts are insufficient or missing**, resulting in valuation conclusions that do not comply with the level of value defined by the Trustee. Many minority interest ESOPs are effectively valued on a quasi-control basis. Is this reasonable or proper? Is the marketability discount appropriate in light of the sponsor company's financial health and the needs of plan participants?

10. **The aging of baby boom participant pools requires that the demographics of plan participants be examined for diversification or retirement needs.** Repurchase obligation is a seminal issue in ESOP valuation. Appraisers should inquire about projected retirement needs of both ESOP participants and other shareholders or significant managers. Repurchase obligation studies are the order of the day for Trustees and sponsor company boards. In some cases, non ESOP shareholders requiring accommodation via stock redemption may have needs or expectations that conflict with needs arising from an accumulation of ESOP participants awaiting contributions and/or distributions for retirement or diversification purposes.

11. **A change in the ESOP Trustee** may bring about a change in the appraiser.

12. **The ESOP valuation fails to reconcile to non-ESOP appraisals or other appraisals used for capital raising or other purposes.** There are reasons why this could or should be the case. However, significant valuation events that fail to reconcile to the ESOP valuation can suggest serious issues.

13. **A lower professional fee is needed or, perhaps, the conclusion of value is not desirable.** Fee sensitivity is arguably a good trait for ESOP Trustees, as long as valuation quality is not compromised. However, shopping the valuation for a targeted treatment or result is a dangerous endeavor.

14. **There are service and timeliness issues with the current appraiser.** The need for expediency cannot compromise accuracy or completeness in the valuation. The timing and responsiveness of information production is the key to a good appraisal experience.

15. **The ESOP is terminating.** Termination events often involve fairness opinions and other advanced considerations, prompting a change in the appraiser or the use of a secondary appraiser to advise the Trustee in a consultancy role. The same may be true for secondary and/or consolidating ESOP transactions.

The Process of Selecting the New ESOP Appraiser

When the decision has been made to select a new qualified appraiser, it is appropriate for the Trustee to begin an orderly process of interviewing more than one potential valuation expert in order to make an informed decision. Therefore, Trustees and/or sponsoring companies should consider the following:

- **Industry Expertise or Valuation Expertise?** Although "industry experts" in a variety of industries are abundant, it is generally advisable to prioritize valuation expertise over industry expertise in the ESOP world. Industry experts, although knowledgeable about their particular industry, frequently lack even a basic understanding of the concept of fair market value as it pertains to a particular level of value in the context of a private company ESOP. It is advisable to look for appraisers with a working and current knowledge of ESOP valuation issues.

- **Is the appraiser a sole practitioner or the member of a firm with other skilled ESOP appraisers** that can readily stand-in if the original practitioner leaves the firm? The involvement of multiple professionals working collectively under the supervision or a senior-level practitioner may provide the back-up that mitigates the potential disruption caused by the departure or unavailability of the legacy/primary appraiser.

- **The ESOP appraisal experience of the business valuation firm**, including the number of ESOP valuations performed over the history of the firm, as well as the current number of ESOP appraisals performed.

- **Non-ESOP appraisal experience of the business valuation firm**. Some ESOP stakeholders might consider a firm that only specializes in ESOP appraisals an advantage. Others could perceive such a service concentration as inherently risky or too professionally confining for the appraiser to gain collateral professional financial services experience.

- **The professional credentials held by the business appraisers within the firm being considered**. Professional valuation credentials generally include the following: Accredited Senior Appraiser (ASA), Accredited in Business Valuation (ABV), Certified Business Appraiser (CBA), Certified Valuation Analyst (CVA), and Chartered Financial Analyst (CFA).

- **Affiliation with the ESOP Association and/or the National Center for Employee Ownership**; articles published; speeches given; conferences attended.

- **The valuation methods typically employed** and the relative weight applied to each.

- **Has a regulatory challenge ever been leveled against the proposed ESOP appraiser?**

- The appraiser's position regarding:
  - **an ownership control price premium** applied to an ESOP's purchase of the employer corporation stock and, conversely, a minority interest discount applied to an ESOP's purchase of employer corporation stock.
  - **a marketability discount** in view of the ESOP participants' put option rights.
  - **the typical range of the marketability discount** applicable to ESOP-owned employer stock.

- **The appraiser's treatment and/or consideration of the ESOP's repurchase obligation.**

- **The appraiser's experience as an expert witness** in litigation or plan audit matters involving the IRS, the DOL, or ESOP participants and the outcomes of such events. It could well be that an experienced ESOP appraiser with limited or no litigation experience is preferable to one that has repeatedly been required to defend their appraisals in audit and litigation proceedings.

- **Estimates of professional fees (both current and on-going).**

- **The appraisal firm's valuation process**, including an understanding of the timing to complete the valuation engagement.

- **The extent to which the financial advisor expects to work interactively with sponsoring company management during the valuation process.**

The Trustee has a role to play in providing pertinent information to the prospective appraisal firms such that they can understand the proposed project and provide a comprehensive proposal of services. As such, the Trustee should provide the following information to the appraiser candidates:

- Historical financial statements (typically 5 years)
- Previous ESOP valuation reports
- History of the subject plan
- Information on the ESOP sponsor company

The Trustee's selection decision should be based on the overall qualifications of the business appraisal firm. Discussion of the probable valuation outcome during the selection phase could be misleading or taint the process. In cases where a new appraiser serves as a review resource to the Trustee, there could be situations when differences of treatments and methodologies are discussed, as well as the impact that valuation modifications or additions would have on an appraisal issued by the previous appraiser. In such cases, the new appraiser has the burden of independence and credibility and Trustees have the obligation of obtaining the best information and not a predetermined outcome from a change in the appraisal firm. As stated previously, shopping the valuation for a targeted treatment or result is a dangerous endeavor.

The selection process should be reasonably documented so that the questions of "why was a change necessary?" and "how was the selection process undertaken?" can be answered by the Trustee.

Conclusion

There are risks involved when making the decision to select a new appraiser, including a change in valuation methodology, a possible meaningful change in share value, and the perceived independence of the Trustee (and appraiser) from the perspective of regulators and/or plan participants. However, in many situations, a change is needed and prudent and a lack of change can be viewed as creating or worsening a valuation issue. The selection process should serve to ensure that the change in appraisers minimizes or mitigates the negative impact on the ESOP, and the ESOP participants (or that a change is accompanied by necessary, long-term considerations, even if a change in the valuation provider results in a meaningful near-term impact on the ESOP) and should be rigorous enough to withstand scrutiny from government regulators and plan participants.

Each year, Mercer Capital assists scores of companies and financial institutions with annual ESOP valuations, as well as with ESOP installation advisory, disputes, and fairness opinions. Give us a call to discuss an ESOP valuation issue in confidence.

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ESOP Valuation Services

Mercer Capital understands ESOPs because we ourselves are an ESOP company. We provide annual appraisals for ESOP trustees as well as fairness opinions and other valuation-related services for ESOP companies and financial institutions. Each year, Mercer Capital assists scores of companies and financial institutions with annual ESOP valuations, as well as with ESOP installation advisory, disputes, and fairness opinions. We are active members of The ESOP Association and the National Center for Employee Ownership (NCEO).

Employee Stock Option Plan Valuation Services

- Annual ESOP Plan Valuation
- ESOP Appraisal Review
- ESOP Feasibility Valuation
- Fairness Opinions
- Complex ESOP Transactions
- ESOP Dispute Resolution
- ESOP Sale or Termination Opinions
- ESOP Second-Stage Transactions

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Valuation of Contingent Consideration in M&A Transactions

Companies often use contingent consideration when structuring M&A transactions to bridge differing perceptions of value between a buyer and seller, to share risk related to uncertainty of future events, to create an incentive for sellers who will remain active in the business post-acquisition, and other reasons. Starting when SFAS 141R (now ASC 805) became effective in 2009, acquiring entities are now required to record the fair value of earn-outs and other contingent payments as part of the total purchase price at the acquisition date. This rule came into effect in the aftermath of the financial crisis when M&A activity slowed to a stand-still. Given the recent experience and continued expectation of increases in M&A activity, a refresher on the new rules may be helpful for CFOs and controllers of companies contemplating acquisitions in 2011.

The Rules

ASC 805, the section of the FASB codification that addresses business combinations, requires that:

» The fair value of contingent consideration be recognized and measured at fair value at the acquisition date. In most cases, recognition of a liability for contingent consideration will increase the amount of goodwill recognized in the transaction.

» Fair value must be re measured for each subsequent reporting date until resolution of the contingency, and any increases or decreases in fair value will show up on the income statement as an operating loss or gain.

What Is Fair Value?

In the case of contingent consideration, fair value represents the amount the reporting entity would have to pay a hypothetical counter-party to transfer responsibility for paying the contingent liability. This amount is basically the present value of the probability-weighted expected amount of the future payment.

Valuation Procedures

The complexity of the procedures necessary to estimate the future payment ultimately depends on the structure of the earn-out.

» For an earn-out structured as a straight multiple of revenue or EBITDA, it may be reasonable in many cases to estimate the expected payment using a single-scenario model by applying that multiple directly to the measure of performance in the financial forecast.

» For a fixed amount payable upon achieving a particular milestone or event, estimating probabilities of various scenarios in a multi-scenario model will be necessary.

» For more complicated earn-outs including thresholds, caps, or tiers, a more complicated modeling technique such as a Monte Carlo simulation or real options analysis will be required. Preparing these analyses generally requires specialized training and software.

The role of the valuation specialist is to integrate this information into the appropriate valuation model, test it for reasonableness, and to articulate the nuances of the inputs and valuation model in such a way that is clear for auditors and other third-party reviewers to understand.

Valuation Inputs

For earn-out structures including milestone payments or tiered schedules, the fair value of the contingent payment is generally most sensitive to the estimate of the probability-weighted expected payment (rather than other inputs such as duration of contingency or discount rate).

Developing reasonable estimates of the probability of future events is inherently difficult, but the use of decomposition and cross-checks will help improve the quality of these estimates. *Decomposition* is the process of breaking down a big event (such as commercialization of a development-stage product) into a series of smaller, more familiar pieces to make the probability estimate process easier. *Cross-checks* using aggregate industry information (such as the average length of time to receive regulatory approval from the FDA) can be helpful to validate assumptions that by nature rely on judgment. Industry expertise can be extremely valuable when selecting a valuation specialist to help with estimating the fair value of contingent consideration. An expert will be able to decompose common pathways into a series of manageable steps to estimate, will have familiarity with available industry data that can be used to help support assumptions, and will be able to effectively explain and defend the assumptions.

Role of a Valuation Specialist

In most cases, you or someone else in your company will likely be the individual most knowledgeable of the potential outcomes. The role of the valuation specialist is to integrate this information into the appropriate valuation model, test it for reasonableness, and to articulate the nuances of the inputs and valuation model in such a way that is clear for auditors and other third-party reviewers to understand. For simple situations it may not be necessary to bring in the outside help of a valuation specialist. For more complicated situations requiring multiple scenarios or Monte Carlo analysis, however, outside support may be necessary. If you have any questions regarding the valuation of contingent consideration or the impact of particular structures on financial reporting procedures, feel free to call or e-mail Travis Harms (harmst@mercercapital.com) to discuss in confidence.

Financial Reporting Valuation Services

In an environment of increasingly complex fair value reporting standards and burgeoning regulatory scrutiny, Mercer Capital helps clients resolve fair value reporting issues successfully. We have the capability to serve the full range of your fair value valuation needs, providing valuation opinions that satisfy the scrutiny of your auditors, the SEC, and other regulatory bodies.

Mercer Capital provides a comprehensive suite of valuation services to assist financial managers with financial reporting requirements. We have the capability to serve the full range of your fair value valuation needs, providing valuation opinions that satisfy the scrutiny of your auditors, the SEC, and other regulatory bodies.

Mercer Capital has the institutional capability to tackle even the most uncommon or complex fair value issues. We understand the sensitivity of financial reporting timing needs and meets your deadline on time, every time.

Financial Reporting Valuation Services

» Purchase Price Allocation Services
» Impairment Testing Services
» Equity-Based Compensation Valuation Services
» Portfolio Valuation Services

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Mercer Capital Highlights

SPEECHES OF NOTE

June 20, 2011
Value Drivers in ESOPs
Eggs & ESOPs Breakfast, sponsored by the New South Chapter of the ESOP Association
Huntsville, Alabama
Nicholas J. Heinz, ASA

July 11-12, 2011
Business Appraisal Review Case Studies
The Business Valuation & Certification Training Center
Chicago, Illinois
Z. Christopher Mercer, ASA, CFA, ABAR

July 14, 2011
Standards and Premises of Value
Webcast Sponsored by the AICPA
Z. Christopher Mercer, ASA, CFA, ABAR
and Travis W. Harms, CFA, CPA/ABV

August 2, 2011
Business Succession Planning
National Business Institute
Memphis, Tennessee
Z. Christopher Mercer, ASA, CFA, ABAR

August 9, 2011
Buy-Sell Agreements
Young Presidents Organization Forum
Memphis, Tennessee
Z. Christopher Mercer, ASA, CFA, ABAR

August 11, 2011
The Business Appraisal Report: Perfecting the Art
Webcast sponsored by BV Resources
Timothy R. Lee, ASA and
L. Paul Hood, Jr., JD, LLM

August 18, 2011
Buy-Sell Agreements
Webcast sponsored by the American Bar Association
Z. Christopher Mercer, ASA, CFA, ABAR
with Louis A. Mezzullo, Esq.

WILSON NAMED VICE PRESIDENT

Mercer Capital is pleased to announce that **Jay D. Wilson, Jr., CFA**, has been promoted to the position of vice president. Jay is a senior member of Mercer Capital's Financial Institutions Valuation Group.

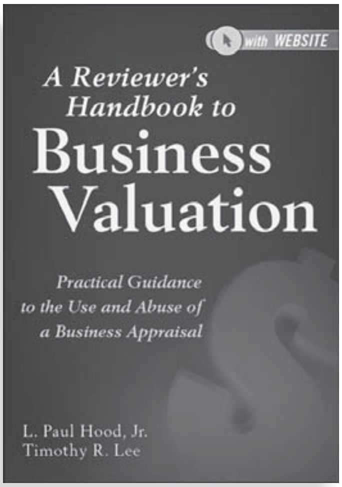
GILMAN NAMED SENIOR FINANCIAL ANALYST

Mercer Capital is pleased to announce that **Madeleine C. Gilman** has been promoted to the position of Senior Financial Analyst. Maddie is a member of Mercer Capital's Financial Institutions Valuation Group.

HARMS COMMENTS ON ACCOUNTING RULES FOR BUSINESS MERGERS

Travis W. Harms, CFA, CPA/ABV, leader of Mercer Capital's Financial Reporting Valuation Group, was recently quoted in an article published in *Compliance Week*, titled "Companies Return to M&A to Find the Rules Have Changed," by Tammy Whitehouse.

In the article, published April 5, 2011, Harms comments on how companies are dealing with the changes to merger accounting brought on by ASC Topic 805, *Business Combinations* (formerly SFAS 141R), as M&A activity begins to increase. According to Harms, some companies are being caught off guard by the rules.



A Reviewer's Handbook to Business Valuation

Practical Guidance to the Use and Abuse of a Business Appraisal

by L. Paul Hood, Jr., JD, LLM and Timothy R. Lee, ASA

Co-written by a business appraiser and tax lawyer, this book is written for users of business valuations and emphasizes the practical side of business valuation. There is something in this book for every person who is involved in the business appraisal process, including business owners, business appraisers, attorneys, CPAs who are not also business appraisers, and other users and reviewers of business

A Reviewer's Handbook to Business Valuation covers:

» The basic valuation process, providing the reader with sufficient information to understand valuation theory without having to become a business appraiser.

» Lessons from the trenches, including alleged errors of omission and commission by business appraisers that have ended up in court decisions.

» A thorough discussion of the business valuation standards.

» The authors' take on 10 burning issues in business valuation that drive attorneys and planners crazy.

About the Authors

L. Paul Hood, Jr., JD, LLM

Paul is a frequent speaker, is widely quoted and his articles have appeared in a number of publications, including *BNA Tax Management Memorandum*, *CCH Journal of Practical Estate Planning*, *Estate Planning*, *Valuation Strategies*, and more. He has spoken at programs sponsored by a number of law schools, including Duke, Georgetown, NYU, Tulane, Loyola (N.O.) and LSU, as well as many other professional organizations, including AICPA and NACVA.

Timothy R. Lee, ASA

Timothy R. Lee holds the Accredited Senior Appraiser designation from the American Society of Appraisers and is a senior vice president and board member of Mercer Capital. Tim began his valuation career in 1994 and currently leads Mercer Capital's Corporate Valuation Service Group.

"*A Reviewer's Handbook to Business Valuation* is a powerful new resource instructing not only reviewers of business valuation as to how to identify issues—it is also a preparer's "must have" checklist for reviewing their own work."

Nancy J. Fannon
Fannon Valuation Group

"In one place you'll find the questions to ask, real-world guidance, the best, most understandable, primer on business valuation that you'll find anywhere, and a list of mistakes that others have made – so that you won't make them."

Stephan Leimberg
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Learn More

For more information about **A Reviewer's Handbook to Business Valuation,** or to order your copy, visit the book's companion website at **www.bvreviewershandbook.com**

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A Reviewer's Handbook to Business Valuation

More information on Page 14

Continued from Page 8:

"Tax Court Upholds Daubert Challenge to Appraisal Expert"

» **It is imperative that your appraiser correct errors and carefully consider how the errors affect the conclusion of value.** Appraisers are human too and do make mistakes from time to time. Errors can easily be made, and in appraisal reports, errors can cascade into bigger errors as they factor themselves in at each level of the analysis, throwing the conclusion of value off even further. In *Boltar*, the appraisers apparently didn't consider how their errors affected their analysis, which the Tax Court termed "fatal."

» **Where an appraiser is not following a required valuation approach format, such as that for conservation easements, or the appraiser desires to use a technique that is "cutting edge" and hasn't been vetted with the appraiser's peers, warning bells should go off!** I normally wouldn't permit my clients to be guinea pigs unless they understood that and were nevertheless willing to do so. I strongly encourage appraisers who are "inventive" to publish articles and speak about their technique first to their peers. I really don't care too much about whether the technique is criticized, because appraisers are notorious in criticizing each other's work. As long as the technique is being used by other appraisers, I'm comfortable with it being employed as long as it is done correctly and consistently.

In Conclusion

The bottom line is to rely upon experienced and respected firms and professionals. Mercer Capital's work product is of the highest quality. Our professionals have been designated as expert witnesses and have testified in federal and state courts and before various regulatory bodies, including U.S. Federal District Court (Several Jurisdictions), County and State Courts (Numerous States), U.S. Tax Court, U.S. Bankruptcy Court, state regulatory bodies, and the American Arbitration Association. To discuss a valuation issue in confidence, please give us a call.

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