1. To whom does Section 409A apply?

Section 409A applies to all companies offering nonqualified deferred compensation plans to employees. We are not attorneys, so we will leave the legal minutiae of that definition for others to grapple with, noting only that generally speaking, a deferred compensation plan is an arrangement whereby an employee (“service provider” in 409A parlance) receives compensation in a later tax year than that in which the compensation was earned. “Nonqualified” plans exclude 401(k) and other “qualified” plans. What is interesting from a valuation perspective is that stock options and stock appreciation rights (SARs), two common forms of incentive compensation for private companies, are potentially within the scope of Section 409A. The IRS is concerned that stock options and SARs issued “in the money” are really just a form of deferred compensation, representing a shifting of current compensation to a future taxable year. So in order to avoid being subject to 409A, employers (“service recipients”) need to demonstrate that all stock options and SARs are issued “at the money” (i.e., with the strike price equal to the fair market value of the underlying shares at the grant date). Stock options and SARs issued “out of the money” do not raise any particular problems with regard to Section 409A.

2. What are the consequences of Section 409A?

Stock options and SARs that fall under Section 409A create problems for both service recipients and service providers. Service recipients are responsible for normal withholding and reporting obligations with respect to amounts includable in the service provider’s gross income under Section 409A. Amounts includible in the service provider’s gross income are also subject to interest on prior underpayments and an additional income tax equal to 20% of the compensation required to be included in gross income. For the holder of a stock option, this can be particularly onerous as, absent exercise of the option and sale of the underlying stock, there has been no cash received with which to pay the taxes and interest.

These consequences make it critical that stock options and SARs qualify for the exemption under 409A available when the fair market value of the underlying stock does not exceed the strike price of the stock option or SAR at the grant date.

3. What constitutes “reasonable application of a reasonable valuation method”?

For public companies, it is easy to determine the fair market value of the underlying stock on the grant date. For private companies, fair market value is not available upon opening the Wall Street Journal each morning. Accordingly, for such companies, the IRS regulations provide that “fair market value may be determined through the reasonable application of a reasonable valuation method.” In an attempt to clarify this clarification, the regulations proceed to state that if a method is applied reasonably and consistently, such valuations will be presumed to represent fair market value, unless shown to be grossly unreasonable. Consistency in application is assessed by reference to the valuation methods used to determine fair market value for other forms of equity-based compensation. An independent appraisal will be presumed reasonable if “the appraisal satisfies the requirements of the Code with respect to the valuation of stock held in an employee stock ownership plan.”

CONTINUED ON PAGE 2
A reasonable valuation method is to consider the following factors:

- The value of tangible and intangible assets
- The present value of future cash flows
- The market value of comparable businesses (both public and private)
- Other relevant factors such as control premiums or discounts for lack of marketability
- Whether the valuation method is used consistently for other corporate purposes

In other words, a reasonable valuation considers the cost, income, and market approaches, and considers the specific control and liquidity characteristics of the subject interest. The IRS is also concerned that the valuation of common stock for purposes of Section 409A be consistent with valuations performed for other purposes.

4. How is fair market value defined?

Fair market value is not specifically defined in Section 409A of the Code or the associated regulations. Accordingly, we look to IRS Revenue Ruling 59-60, which rather famously defines fair market value as “the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.”

5. Does fair market value incorporate a discount for lack of marketability?

Among the general valuation factors to be considered under a reasonable valuation method are “control premiums or discounts for lack of marketability.” In other words, if the underlying stock is illiquid, the stock should presumably be valued on a non-marketable minority interest basis.

This is not without potential confusion, however. Stock issued to ESOP participants is generally covered by a put right with respect to either the Company or the ESOP. Accordingly, business appraisers often apply marketability discounts on the order of 0% to 10% to ESOP shares. Shares issued pursuant to a stock option plan may not have similar put rights attached, and therefore may warrant a larger marketability discount. In such cases, a company that has an annual ESOP appraisal may not have an appropriate indication of fair market value for purposes of Section 409A.

6. Are formula prices reliable measures of fair market value?

In addition to independent appraisals, formula prices may, under certain circumstances, be presumed to represent fair market value. Specifically, the formula cannot be unique to the subject stock option or SAR, but must be used for all transactions in which the issuing company buys or sells stock.

7. What are the rules for start-ups?

For purposes of Section 409A compliance, start-ups are defined as companies that have been in business for less than ten years, do not have publicly traded equity securities, and for which no change of control event or public offering is reasonably anticipated to occur in the next twelve months. For start-up companies, a valuation will be presumed reasonable if “made reasonably and in good faith and evidenced by a written report that takes into account the relevant factors prescribed for valuations generally under these regulations.” Further, such a valuation must be performed by someone with “significant knowledge and experience or training in performing similar valuations.”

This presumption, while presented as a separate alternative, strikes us as substantively and practically similar to the independent appraisal presumption described previously. Some commentators have suggested that the valuation of a start-up described in the preceding may be performed by an employee or board member of the issuing company. We suspect that it is the rare employee or board member that is actually qualified to render the described valuation.

8. Who is qualified to determine fair market value?

A reliable independent appraisal will be prepared by an individual or firm that has a thorough educational background in finance and valuation, has accrued significant professional experience preparing independent appraisals, and has received formal recognition of his or her expertise in the form of one or more professional credentials (ASA, ABV, CBA, CVA, or CFA). The valuation professionals at Mercer Capital have the depth of knowledge and breadth of experience necessary to help you navigate the potentially perilous path of Section 409A.
**BROAD CHANGES IN USPAP 2006**

The Uniform Standards of Professional Appraisal Practice (USPAP) are updated and published by the Appraisal Foundation each year. USPAP 2006 became effective on July 1, 2006. Unlike some previous updates, the revisions in USPAP 2006 are substantial, and require careful review not only by all business appraisers, but also by users of appraisal services.

The overall theme of the revisions found in USPAP 2006 can be summarized in one word: **credibility**. In fact, this theme is so important that a definition of credibility has been added as a defined term:

**CREDIBLE**: worthy of belief.

Comment: Credible assignment results require support, by relevant evidence and logic, to the degree necessary for the intended use.

There are a number of substantive changes in USPAP 2006. For example, the “Departure Rule” has been eliminated and a “Scope of Work Rule” has been added. Scope of Work becomes a defined term:

**SCOPE OF WORK**: the type and extent of research and analyses in an assignment.

Unlike the Departure Rule, which addressed only a single aspect of appraisal development, i.e., the application of a specific requirement, the Scope of Work Rule addresses both the application and the extent of development. Rather than focusing on agreed-upon departures from USPAP guidelines, the new focus of scope of work requires the appraiser to explain what he or she has done, and importantly, what has not been done in an appraisal.

These changes are significant and applicable to all appraisers. All the standards, including Standards Rules 9 and 10, which pertain to the conduct and reporting of business appraisal assignments, were edited to eliminate references to the Departure Rule and to conform to the new Scope of Work Rule.

**Changes Pertaining to Business Appraisal**

In addition to the annual updates, the Appraisal Standards Board occasionally conducts a detailed examination of the form and content of a portion of USPAP. Standards 9 and 10 were so-examined in USPAP 2006, resulting in “extensive modifications” to both business appraisal standards.

The remaining discussion will touch primarily on the significant changes in Standard 9 by comparing USPAP 2005 and USPAP 2006.

The Standards were edited to clarify that appraisals relate to **ownership interests** in businesses or other intangible assets. The beginning of Standard 9 was changed:

2005: In developing a business or intangible asset appraisal, an appraiser must….

2006: In developing an appraisal of an interest in a business enterprise or intangible asset, an appraiser must…. [emphasis added]

This new language now conforms with language in the ASA Business Valuation Standards, which relate to the

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**Mercer Capital Highlights**

**PROFESSIONAL DESIGNATIONS**

Brent A. McDade has been awarded the Business Valuator Accredited for Litigation (BVAL) credential from the Institute of Business Appraisers, Inc. (IBA). The BVAL designation is designed to recognize experienced business appraisers who demonstrate their ability to competently present expert testimony which supports their objective conclusion of value.

Mercer Capital professionals achieved a 100% pass rate on this year’s Chartered Financial Analyst exams, which are sponsored by the CFA Institute.

Conley W. Patton passed the Level 3 exam, and is therefore entitled to use the CFA designation.

In addition, B. Tyler Beckman, Eden A. Gipson, Lucas M. Parris and Jay D. Wilson, Jr. passed the Level 2 exam, while Kristin P. Cicala, Brooks K. Hamner, Laura J. Hoffmeister, and B. Patrick Lynch passed the Level 1 exam.

The CFA charter is a globally recognized standard of expertise in investment analysis and portfolio management.

**NEW HIRES**

Megan M. Bartels, Brooks K. Hamner, and Sujan Rajbhandary have joined Mercer Capital as financial analysts.

**PROMOTIONS**

B. Tyler Beckman, Lucas M. Parris and Jay D. Wilson, Jr. have been promoted to Senior Financial Analysts.
development and reporting of valuations of “businesses, business ownership interests, and securities.”

Standards Rule 9-2 addresses the identification of important aspects of an appraisal. The new SR 9-2 calls for the identification of “the standard (type) and definition of value and the premise of value.” Prior language noted only “type and definition.” Interestingly, neither standard, type, nor premise of value are defined terms in USPAP. Both standard of value and premise of value, however, are defined terms in the ASA Business Valuation Standards.

Standard of Value. The identification of the type of value being used in a specific engagement; e.g., fair market value, fair value, investment value.

Premise of Value. An assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation; e.g., going concern, liquidation.

It is clear that USPAP 2006 is calling for much greater specificity in the definition of appraisal assignments. This is an important clarification to what has long been good appraisal practice.

USPAP 2006, like prior versions, calls for the identification of all buy-sell agreements, investment letter stock restrictions, restrictive corporate charter or partnership agreement clauses, and similar features or factors that may have an influence on value, and adds option agreements to the list.

SR 9-2 is supplemented to require identification of “the extent to which the interest is marketable and/or liquid.”

Standards Rule 9-4 addresses the collection and analysis of all information necessary to conduct credible business appraisals. Both 2005 and 2006 versions provide the usual list of appraisal considerations, which primarily parallel what we call the “Basic 8 factors” of Revenue Ruling 59-60. However, two important sub-paragraphs have been added in USPAP 2006 (SR 9-4(c) and SR 9-4(d)), the significance of which will only become apparent over time.

SR 9-4(c) An appraiser must, when necessary for credible assignment results, analyze the effect on value, if any, of buy-sell and option agreements, investment letter stock restrictions, restrictive corporate charter or partnership agreement clauses, and similar features or factors that may influence value.

USPAP 2005 required the identification of buy-sell agreements and other agreements that might have an influence on value. USPAP 2006 adds the parallel requirement that the appraiser “analyze the effect on value, if any,” of such agreements as are identified. What does this new requirement mean? Let’s consider an example.

Assume an appraiser is valuing a small, minority interest in a closely held business. The interest can be sold to outside parties, but it is first subject to a right of first refusal (ROFR). The ROFR requires that any offer made by an outside party for the shares be offered, on the same terms and conditions, first to the company, then to the other shareholders, and then back to the company, allowing 60 days for consideration at each stage. Common sense says that the existence of the ROFR restricts the marketability of the subject interest and likely has a negative effect on value. What tools will the appraiser use to “analyze the effect on value, if any” of the existence of the right of first refusal? Such analysis almost presupposes a need to be able to quantify the effect on value, if any. At the very least, it seems to require an ability to discuss the impact on value in a concrete way.

Did You Know?

The five most popular downloads from Mercer Capital’s website for the first six months of 2006 are:

1. Sample Spreads .................................................... 1,569
2. Southeast Bank Group .......................................... 1,219
3. Purchase Price Allocation ..................................... 1,141
4. Mercer Capital Investment Banking Qualifications ......................................... 1,414
5. Mercer Capital Corporate Qualifications .............................................. 271

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capitalized (or discounted) to account for the way that likely buyers of controlling interests of similar businesses would look at the particular business (or a controlling interest in it). Perhaps a discussion of the state of the mergers and acquisitions market and ascertaining the degree of consolidation in the Company’s industry would be helpful, as well.

What does the new rule suggest about the valuation of minority interests? Most minority interests lack much or any control. Appraisers address this issue initially by developing value indications at the marketable minority interest (as-if-freely-traded) level of value, where it is assumed that minority shares lack control over enterprises.

But minority interests in closely held businesses lack active markets, and their lack of marketability must be considered when appraising them. Wouldn’t the application of benchmark analysis using restricted stock studies or pre-IPO studies satisfy the requirement? The (binding) comment adds clarity to the rule:

Comment: An appraiser must analyze factors such as holding period, interim benefits, and the difficulty and cost of marketing the subject interest.

Equity interests in a business enterprise are not necessarily worth the pro rata share of the business enterprise interest value as a whole. Also, the value of the business enterprise is not necessarily a direct mathematical extension of the value of the fractional interests. The degree of control, marketability and/or liquidity or lack thereof depends on a broad variety of facts and circumstances that must be analyzed when applicable.

The interesting thing about this addition in SR 9-4(d) is the very specific mention of factors to consider when analyzing the impact of (lack of) marketability. The language is so specific, in fact, that it seems to presuppose an ability to quantify the impact on value of the noted factors. Three factors are mentioned:

1. Holding period. When valuing business enterprises, the “holding period” is considered to be, effectively, forever. We discount the expected cash flows into perpetuity. However, when valuing minority interests of business enterprises, there is always an explicit (or implicit) consideration of the expected holding period of the investment. Some appraisers and some courts seem to have problems discussing the concept of expected holding periods—presumably because the holding period of an investment is almost never known with precision.

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**Mercer Capital On The Road**

**August 31, 2006**
“Adjusting Multiples from Guideline Public Companies”
BV Resources Teleconference
To register, visit www.bvresources.com
Timothy R. Lee, ASA, panelist

**September 12, 2006**
FCG Fall Conference
Phoenix, Arizona
“IPO Studies v. Restricted Stock Studies v. QMDM - What’s An Analyst To Do?”
Travis W. Harms, CPA/ABV, CFA

**September 18, 2006**
“Buy - Sell Agreements: Ticking Time Bomb or Reasonable Resolution?”
Virginia Society of CPAs’ 7th Annual Business Valuation, Fraud and Litigation Services Conference
Richmond, Virginia
Z. Christopher Mercer, ASA, CFA

**October 19-20, 2006**
“Today’s Word on Lack of Marketability”
CICBV/ASA Annual Conference
Toronto, Canada
Z. Christopher Mercer, ASA, CFA

**November 6, 2006**
“Marketing with the Newest Technology Tools”
IGAF Conference
Las Vegas, Nevada
Barbara Walters Price

**November 30 - December 1, 2006**
Topic TBD
Arkansas AICPA Meeting
Little Rock, Arkansas
Timothy R. Lee, ASA

**December 3-4, 2006**
“Buy - Sell Agreements: Ticking Time-Bomb or Reasonable Resolution?”
“Ask the Experts Panel”
AICPA Business Valuation Conference
Austin, Texas
Z. Christopher Mercer, ASA, CFA

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To book a Mercer Capital professional as a speaker at your next conference or CLE/CPE meeting, please contact Barbara Walters Price at priceb@mercercapital.com.
These same appraisers and courts, however, seem unconcerned when employing discounted cash flow estimates, where the expected future cash flows are never known with precision, either in timing or amounts. Appraisers sometimes address this problem by using multiple forecasts (best case, worst case, most likely) and then weighting them based on their judgment. More frequently, appraisers will develop their “most likely” forecasts and then base their value indications based on those forecasts.

With the new requirement in USPAP to specifically consider the expected holding period of (minority) investments being appraised, it would appear that we will need to become comfortable with a “most likely” concept of the expected holding period. In any event, to “analyze the effect on value, if any,” on the value of a subject interest of the relevant holding period will require the use of tools that many appraisers do not currently employ on a regular basis.

2. Interim benefits. Clearly, when valuing business enterprises, appraisers consider interim benefits, either explicitly or implicitly, through the use of discounted cash flow, capitalization of income, or market-based methods. In valuing minority interests of enterprises, the consideration of interim benefits would entail the estimation of expected distributions or dividends, as well as the expected terminal value to be received at the expected exit (end of holding period) for the investment. A discounted cash flow analysis including expected interim benefits and terminal value over the expected holding period could prove helpful in analyzing the effect on value, if any, of these two factors when appraising minority interests of businesses.

Current methods employed by many appraisers to develop marketability discounts, including benchmark analysis using restricted stock studies or pre-IPO studies, or using restricted stock studies transactions to make guideline comparisons, do not contain an explicit consideration of “interim benefits.” In fact, virtually none of the companies whose restricted stock transactions are in the various data bases have paid dividends at all.

3. Difficulty and cost of marketing. USPAP’s requirement to consider difficulty and cost of marketing is quite interesting. When valuing business enterprises (controlling interests), the “difficulty and cost of marketing” must be factored into the prices paid by market participants. There is no other place for its consideration. In other words, if buyers are difficult to find, they will know that they, too, may face difficulties in marketing the business at future dates, and will factor those costs into the prices paid today. There would therefore be an implicit consideration of this factor when employing multiples based on guideline transactions, or an explicit consideration in developing the discount rate for the enterprise.

When valuing minority interests of business enterprises, it would seem that a corresponding consideration of “difficulty and cost of marketing” could be developed with the discount rate to be applied to the interim benefits (interim distributions plus expected terminal value) over the expected holding period of the investment. Again, the consideration of the “difficulty and cost of marketing” could require the use of a discounted cash flow analysis to value minority interests in the context of enterprise appraisals.

Standards Rule 9-5 was also revised to require greater reconciliation of information and valuation approaches, methods and procedures.

SR 9-5 (2005). In developing a business or intangible asset appraisal, an appraiser must reconcile the indications of value resulting from the various approaches to arrive at a value conclusion.

The comment in 2005 required a “consideration” of the quality and quantity of data leading to each indication of value. In USPAP 2006, Standards Rule 9-5 has been

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**Mercer Capital’s Bank Watch**

Mercer Capital’s Bank Watch, a monthly publication, is being reintroduced in early September at the request of our clients and referral sources. Delivered via e-mail, we have expanded the publication to include public market indicators such as the Southeast Bank Group Index, as well as M&A market indicators. Covering eight states, Alabama, Arkansas, Georgia, Kentucky, Louisiana, Mississippi, Missouri, and Tennessee, we follow and discuss recent transactions. And, of course, Mercer Capital’s Southeast Bank Group is included. If you are a banker or advise bankers, you cannot be without this complimentary publication.

To receive a complimentary subscription to Mercer Capital’s Bank Watch, just provide us your e-mail address by visiting www.mercercapital.com. If you would prefer to receive a hard copy, the cost is $99 per year for twelve issues.
expanded to require additional reconciliation. In developing an appraisal of an interest in a business enterprise or intangible asset, an appraiser must:

SR 9-5(a) reconcile the quality and quantity of data available and analyzed within the approaches, methods, and procedures used, and...

SR 9-5(b) reconcile the applicability or relevance of the approaches, methods and procedures used to arrive at the value conclusion(s).

Two definitions of the word reconcile, taken from Merriam-Webster Online, shed light on these new rules:

2 : to make consistent or congruous <reconcile an ideal with reality>

4a : to check (a financial account) against another for accuracy b : to account for

The bottom line of the extensive revamping found in Standard 9 in USPAP 2006 is that the standards call for greater effort on the part of appraisers to provide credible appraisal results. The requirements include greater specificity of analysis, guidance for specific analysis of the value-impact of key factors, and greater efforts to reconcile the various aspects of the appraisal process with the conclusion(s) of an appraisal.

Because of space limitations, we will not address the corresponding revamping of Standard 10, which has been revised to require greater specificity of reporting the results of the analysis of appraisals.

Concluding Comments

USPAP 2006 calls all appraisers to become more credible, or worthy of belief. That message is clear from our review of the new standards. In addition, from the perspective of business appraisers, there is a call for greater specificity in report assignment identification and in the factors to be identified and analyzed in valuation reports. Finally, the addition of language calling for appraisers to “analyze the effect on value, if any” for key factors seems to come close to the need for the ability to quantify those effects, if any.

Clearly, the revisions to the Uniform Standards of Professional Appraisal Practice warrant careful study by all business appraisers and users of business appraisals.

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USPAP 2006 calls all appraisers to become more credible, or worthy of belief. That message is clear from our review of the new standards.

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**In This Issue...**

- 8 Things You Should Know About Section 409A
- Broad Changes in USPAP 2006
- Mercer Capital’s Bank Watch Returns
- Buy-Sell Agreements: Ticking Time Bomb or Reasonable Resolution?
  *Coming Winter 2006*

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**Chapters include:**

- Fixed priced agreements
- The six defining elements
- Formula agreements - Do they work?
- Real world examples

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**Buy - Sell Agreements**

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