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Marginal Credentials Undermine Taxpayer's Appraiser's Report

Josephine T. Thompson died May 2, 1998 owning approximately 20% of the outstanding common stock of Thompson Publishing Company, Inc., publisher of *Thomas Register*, an industrial directory. As related in *Estate of Thompson, T. C. Memo 2004-174, July 26, 2004*, the estate claimed a fair market value of \$1,750,000 for the interest, while the IRS claimed that the value should be \$35,273,000.

"The Tax Court found the estate's valuation to be 'deficient and unpersuasive' . . ."

Although the company and the decedent were both domiciled in New York, the estate appointed as its appraisal expert an Alaska lawyer, assisted by a CPA. The estate also retained the Alaska lawyer to represent it before the IRS, in part, because the representatives felt that they would get a better shake from the Alaska IRS office than from the New York office.

The Tax Court found the estate's valuation to be "deficient and unpersuasive," citing the lack of experience and training of both the lawyer and CPA, and their lack of membership in any professional appraisal organizations. The Court also did not like the fact that the lawyer was also serving as administrator for the estate, fearing that this would undermine his independence as an appraiser.

A major issue in the appraisal analysis was the anticipated future impact on Thompson of the migration of the data provided by *Thomas Register* from print to Internet media. This migration was under way, but not complete, in 1998. The appraiser for the estate took a very pessimistic view of the outcome of this transition, and accounted for it with both a heavy cost projection against future earnings, and a sizeable boost in the return-on investment discount rate.

The Judge had before him actual financial results for Thompson for several years after 1998 and

could see how things worked out for the company. Also, following the dicta that "actions speak louder than words," he noted that Thompson management had continued to pay a rather handsome dividend in 1998, concluding that they did not seem to share the appraiser's pessimism.

The Court had scarcely a better opinion of the IRS's appraiser than he did of the estate's, criticizing his choice of comparable companies and treatment of working capital. Said the Judge, "respondent's expert appeared to be concerned with numbers only and did not appear to make an effort to base his valuation of (Thompson) on a real company. His sterile approach is reflected both in his comparable public company analysis and in his discounted cashflow."

The Court performed its own appraisal, and concluded a value of \$13,525,240. He did not charge the taxpayer an undervaluation penalty, arguing that "the evaluation in this case of such intangible (Internet) risks and opportunities was difficult and imprecise." He also noted that his value conclusion was closer to the estate's valuation than to the IRS's valuation. ■

FASB Issues Proposal on Fair Value Measurements

The Financial Accounting Standards Board (FASB) has issued an Exposure Draft, *Fair Value Measurements*, which seeks to provide a guidance framework for practitioners in measuring fair value for financial reporting purposes.

As has been noted earlier, there is a general trend toward the increasing use of fair value concepts in financial accounting. This is a global trend, which can be expected to be felt increasingly in the United States as accounting regulatory bodies seek to unify the accounting

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FASB Issues Proposal on Fair Value Measurements

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principals used here and abroad.

The Exposure Draft seeks to set forth a framework for measuring fair value which would apply to financial and non-financial assets and liabilities alike, improving the consistency, comparability and reliability of these measurements.

FASB addressed several key concepts in the Exposure Draft including the question of whether *fair value* is the same thing as *fair market value*, a key issue that may divide corporate financial reporting managers and corporate tax managers. Here's how FASB addressed the issue:

"Through input received from constituents, the Board learned that the definition of fair value used for financial reporting purposes often is confused with the similar definition of fair market value used for most federal tax matters. Specifically, Internal Revenue Service Revenue Ruling 59-60 defines fair market value as 'the price at which 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.' That definition of fair market value represents the legal standard of value in many valuation situations.

"FASB addressed several key concepts in the Exposure Draft including the question of whether fair value is the same thing as fair market value . . ."

"Because the definitions of fair market value and fair value are similar, both emphasizing the need to consider the actions of marketplace participants (willing buyers and sellers) in the context of a hypothetical exchange transaction, some constituents asked the Board whether, in its view, they are the same or different. The Board believes that the measurement objectives embodied in the definitions are essentially the same. However, the Board observed that the definition of fair market value has a significant body of interpretive case law, developed in the context of tax regulation. Because such interpretive case law, in the context of financial reporting, may not be relevant, the Board chose not to simply adopt the definition of fair market value, and its interpretive case law, for financial reporting purposes."

In practice, FASB's recognition that the definition of *fair market value* used for most federal tax matters may not be relevant in the context of financial reporting, should allow corporate tax managers to continue to utilize different valuation approaches and methods for certain assets and liabilities, even if the resulting conclusions differ from those used by the entity's financial reporting managers.

Another key concept addressed in the Exposure Draft is the establishment of a "Fair Value Hierarchy" that includes three "levels" (i.e., methods to estimate fair value). Under this concept an entity should use the highest level appropriate in estimating the fair value of an item. A brief outline of the three levels is presented below:

Level 1 Estimates (the highest level) – Level 1 estimates are based on quoted prices in active markets on an *identical* asset or liability. In order to use the quoted price, the entity must have immediate access to the market (e.g., the entity must be able to exchange the asset or liability as-is within a reasonable period).

Level 2 Estimates – Level 2 estimates are based on quoted prices in active markets for *similar* assets and liabilities, adjusted as appropriate for differences. The price effect of the differences must be objectively determinable in order to be considered within this level.

Level 3 Estimates – If quoted prices for identical or similar assets or liabilities in active markets are not available, or if the effect on fair value of differences between similar assets and or liabilities are not objectively determinable, fair value is estimated using multiple valuation techniques consistent with the market, income and cost approaches whenever the information necessary to apply those techniques is available without undue cost or effort.

In practice, most independent valuation analyses used for purchase price allocations, impairment testing and "cheap" stock issues will be characterized as Level 3 Estimates and to lesser extent, Level 2 Estimates. Level 1 estimates will mostly be utilized in the context of financial institutions holding portfolios of marketable securities.

FASB plans to hold a public roundtable in September 2004 to gather additional input. The document is available on FASB's website at www.fasb.org. ■

Delaware Chancery Court Uses Common Sense In Selecting Appraisal Methods

What is the better method to use in appraising a business, discounted cash flow (DCF) or comparison to comparable companies? If you study two recent Delaware Chancery Court appraisal cases, you'll conclude that the answer is "it depends."

In *Doft & Co., First Trust Corp. v. Travelocity.com Inc., C.A. No. 19734* (June 10, 2004), the Court was asked to determine the value of a minority interest in Travelocity.com Inc., the on-line travel service. The appraisal action arose out of a merger in which the majority shareholder of Travelocity (Respondent) cashed out the minority shareholders (Petitioners) at a price of \$28 per share.

Petitioner's expert employed a discounted cash flow approach, using management projections, together with a comparable company analysis, concluding that the company had a value of at least \$35 per share.

Respondent's expert, also using a discounted cash flow approach and a comparable company analysis, concluded a value of \$20 per share. Both experts used the same comparable company, Expedia, Inc., in performing their comparable company analysis.

After analyzing the projections used by both parties, the Judge concluded that the inputs used by the experts, the projections of future revenues, expenses and cash flows, "were not shown to be reasonably reliable." This conclusion was reached, in part, because "the industry was so new and volatile that reliable projections were impossible." The Court's confidence in the projections was not enhanced by the fact that the Respondent's expert's discounted cash flow produced values ranging from \$11.38 to \$21.29, notwithstanding the fact that the Respondent had actually paid \$28 per share for the minority interest.

Having lost faith in the DCF approach, the Court chose to rely on an analysis which compared Travelocity to Expedia, and concluded a value of \$30.43 per share.

In *In Re Emerging Communications, Inc. Shareholders litigation, Consolidated C.A. No. 16415*, (June 4, 2004), the subject company was ECM, Inc., a telephone company providing local wired and cellular telephone service in the US Virgin Islands.

The transaction in question involved buying out the public shares in ECM, converting it to a private company. The transaction (done in two steps) took place at \$10.25 per share.

The Plaintiffs claimed that the fair value of ECM at the time of the merger was \$41.16 per share. Defendant's expert valued the company at \$10.38 per share. Both experts relied primarily on the discounted cash flow method to reach their conclusions.

"Having lost faith in the DCF approach, the Court chose to rely on an analysis which compared Travelocity to Expedia . . ."

The four-fold difference between the valuations of these two experts arose primarily from two factors. Defendant used projections prepared in March, 1998 while Plaintiffs used projections prepared in June, 1998. Defendant discounted its projections using a discount rate of 11.5%, while Plaintiffs used a discount rate of 8.5 to 8.8%.

The Court analyzed both appraisals in great detail, finally opting for the June projections and a discount rate of 8.69%. This produced a value of \$38.05 per share.

Defendant urged the Court to give weight to the public trading price of ECM's common stock prior to the merger, claiming that ECM was traded in an efficient market and that the \$7.00 per share market price was a reasonable reflection of its value. Respectfully disagreeing with testimony from Professor Burton Malkiel of Princeton University that ECM's stock traded in an efficient market, the Court concluded that the stock price of ECM merited little or no weight. Among other reasons, the Court reached this conclusion because the market had never had the benefit of disclosure of the June projections.

Finding also that there were no other comparable companies that would shed light on the value of ECM, the Court concluded a fair value of \$38.05.

These two cases, decided within days of each other, illustrate that there can be no hard and fast rules about which approaches to value deserve the greatest weight in a valuation analysis. The circumstances dictate. ■

Hempstead Appraisers Attend AITF Session

Andrew Wiest, ASA and **John Hempstead, ASA, CFA** attended an all day meeting of the Appraisal Issues Task Force (AITF) held in Norwalk, Connecticut on August 2, 2004. The session was held, with representatives of the SEC and FASB, to provide advice and input from the business appraisal profession to these bodies concerning pending regulatory developments in the area of fair value accounting. Of particular interest were the pending FASB Exposure Draft, *Fair Value Measurements* and prospective changes to business combination accounting under SFAS 141.

The Appraisal Issues Task Force is an organization of business valuation professionals which provides advisory input to the SEC, FASB, and other groups on issues related to the use of fair value concepts in financial accounting. Hempstead & Co. is an active participant in AITF matters.

The material presented in the Hempstead Letter should not be construed as definitive legal, accounting, financial, or business advice nor should it be acted upon without consultation with legal or other professional counsel.

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We'd like to hear from you! Please contact us regarding information found in *The Hempstead Letter*, or with any mailing address updates.



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