

# Valuation Vantage<sup>®</sup>

Insights and Perspectives on Leading Corporate Finance Valuation Issues<sup>®</sup>

Spring 2008

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## The McLean Group's Valuation Practice

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

## Allocating Value Among Different Classes of Equity

The McLean Group's Andy Smith (Partner and Senior Managing Director of the Valuation Practice) and Jason Laurent (Senior Analyst) recently authored an article entitled "Allocating Value Among Different Classes of Equity" published in the *Journal of Accountancy*, the monthly publication of the American Institute of Certified Public Accountants (AICPA).

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## SEC Approves New NASD Rule 2290 Regarding Fairness Opinions

Effective December 8, 2007, new NASD Rule 2290 (Fairness Opinions) requires specific disclosures and procedures addressing conflicts of interest when member firms provide fairness opinions in change of control transactions, such as a merger, a sale, or purchase of assets.

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## Determination of the Useful Life of Intangible Assets

FASB Staff Position (FSP) 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Assets*. The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under Statement 142 and the period of expected cash flows used to measure the fair value of the asset under FASB Statement No. 141 (revised 2007), *Business Combinations*, and other U.S. generally accepted accounting principles (GAAP).

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*“Determination of the Useful Life...” continued from p. 1*

In practice, the useful life of a recognized intangible asset under Statement 142 is often different from the period of expected cash flows used to measure the fair value of the asset in a business combination when the underlying arrangement includes renewal or extension terms. Accordingly, FSP FAS 142-3 specifies that:

*“In developing assumptions about renewal or extension used to determine the useful life of a recognized intangible asset, an entity shall consider its own historical experience in renewing or extending similar arrangements; however, these assumptions should be adjusted for the entity-specific factors in paragraph 11 of Statement 142. In the absence of that experience, an entity shall consider the assumptions that market participants would use about renewal or extension (consistent with the highest and best use of the asset by market participants), adjusted for the entity-specific factors in paragraph 11 of Statement 142.”*

For example, in applying the income approach, “an entity shall consider the period of expected cash flows used to measure the fair value of the asset.” The FSP provides two illustrative examples — the first about a technology license and the second about customer relationships. FSP FAS 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, with no early adoption. ♦

*“Allocating Value Among Different...” continued from p. 1*

The six-page article highlights the following points:

- Many companies are being financed with hybrid forms of capital that go well beyond plain vanilla common equity and interest-bearing debt. It is not unusual for a business to carry debt that can be converted to equity or equity that is entitled to a liquidation preference. To make things worse, some rounds of financing incorporate caps, accrued dividends, performance warrants, and other valuation complexities. Understanding these financial structures and their impact on value is essential for all interested parties.
- It is necessary for board members, executive officers, CFOs, auditors and private equity investors to comprehend option-pricing models used to determine the per share values of common and preferred shares.
- The AICPA Practice Aid, Valuation of Privately-Held-Company Equity Securities Issues as Compensation, describes three methods of allocating value between preferred and common equity, which include:
  - Current Value Method (CVM)
  - Probability-Weighted Expected Return Method (PWERM)
  - Option-Pricing Method (OPM)

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*“Allocating Value Among Different...” continued from p. 2*

- The option-pricing method, which is based on the Black-Scholes model, is a common method for allocating equity value between common and preferred shares and should be considered for companies that have recently raised capital and do not foresee an imminent exit event.
- Valuation models must be tailored to the specific facts and circumstances of the equity in the company being valued.

To view the full-length article, please click [here](#). ♦

*“SEC Approves New NASD Rule...” continued from p. 1*

Although not required by statute or regulation, fairness opinions have become commonplace in change of control transactions following the 1985 Delaware Supreme Court case of *Smith v. Van Gorkom*, in which a corporate board was held to have breached its fiduciary duty of care by approving a merger without adequate information about the transaction, including information on the value of the company and the fairness of the offering price.

In addition to providing a basis for the exercise of care by the board of directors, a fairness opinion is often provided to shareholders as a part of the proxy materials relating to a change of control transaction. Fairness opinions express a conclusion as to the whether the consideration offered in a transaction is within the range of what would be considered “fair.” However, such opinions generally do not offer an opinion as to whether the consideration offered is the best price, or other matters, such as solvency issues, that may arise from the transaction.

Under the SEC’s proxy rules, certain disclosures about potential conflicts of interest are required to be provided to potential investors and shareholders. NASD Rule 2290 is a complementary rule that requires broker-dealers that render fairness opinions to inform investors and shareholders about any potential conflicts of interest that may exist with the firm rendering the fairness opinion and the issuer.

In summary, if a member firm knows or has reason to know, at the time a fairness opinion is issued to a company’s board, that the opinion will be provided or described to the company’s public shareholders, the firm must make the following disclosures in the fairness opinion:

- If the broker-dealer will receive any compensation contingent on the successful completion of the transaction for acting as a financial adviser to any party to the transaction or otherwise.
- Any contemplated or existing material relationships involving the payment or receipt of compensation between the broker-dealer and any party to the transaction during the last two years.
- If the firm has independently verified any information supplied by the company requesting the fairness opinion, which is a substantial basis for the opinion and, if so, describe the information.
- Whether the fairness opinion was approved or issued by a fairness committee.
- Whether the fairness opinion expresses an opinion about the fairness of the compensation to any of the company’s insiders, relative to the compensation to the company’s public shareholders. ♦

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## Spotlight on Court Cases



### **Kenneth John Cannon, Jr. v. Lenard Bertrand, et al.**

April 16, 2008

In this case, the selling partner was not satisfied with the payment offered to him for his 33% interest in a real estate partnership. As a result, the selling partner took his case to court and it was determined that there should be a 35% discount on his ownership interest. He appealed this decision, but the decision was not changed by the appeals court. The appeals court concluded that the partnership agreement for the real estate partnership did not specifically address what the payment to the selling partner would be and had the agreement addressed this issue, the courts would not have had to be involved. Also, the appeals court concluded that the discount was in a reasonable range as the expert in the trial court cited an average 38% discount from an article on pricing non-publicly traded limited partnerships.

### **Cox Enterprises, Inc. v. News-Journal Corp.**

December 21, 2007

In this case, the dispute centered on how much News-Journal Corporation (“NJC”) was required to pay Cox given past excessive charitable contributions by NJC to the detriment of Cox. NJC’s expert used a discounted cash flow (“DCF”) analysis to value NJC while Cox’s expert used a comparable company analysis. The Court ruled that the DCF analysis was undervaluing NJC by rewarding wrongdoing and the comparable company analysis was more relevant since it adjusted NJC’s operating margin to a set of comparable companies’ operating margin. However, the Court also ruled that Cox could not receive additional damages since the operating margin of NJC was already adjusted to reflect a normalized operating margin. ♦

## Recent Valuation Engagements



**Business Valuation**  
 Online Education Products & Services  
 As Business Valuers & Financial Advisors



**Purchase Price Allocation**  
 Open Source Security Software  
 As Business Valuers & Financial Advisors



**Goodwill Impairment Test**  
 eWaste Recycling Services  
 As Business Valuers & Financial Advisors