

# Valuation Vantage<sup>®</sup>

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

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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 Valuation Services Group provides business valuation services, including intangible asset and financial security valuations for a variety of transaction, financial reporting and tax purposes.

## Section 409A – Compliance Update

Section 409A of the Internal Revenue Codes (“Section 409A”) regulates the federal income tax treatment of “nonqualified deferred compensation,” which refers to compensation earned by an employee in one year but paid in a future year. Section 409A does not apply to elective deferrals to such qualified plans as: 401(k), 403(b), or 457(b) plans.

The Internal Revenue Service (“IRS”) has begun auditing compliance with Section 409A. Based on the Information Document Requests (“IDRs”) provided by the IRS, audited companies are expected to identify detailed payment information with respect to the applicable year of audit and take potential legal positions with respect to such information, including identification of the following:

- Each plan and arrangement providing for a legally binding right in one year and payment in a subsequent year that is not subject to Section 409A; the basis for the position that the plan is not subject to Section 409A; and if that basis is predicated on the short-term deferral exclusion, the terms of the plan or arrangement, including any relevant substantial risk of forfeiture;

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## When to Roll Forward a Goodwill Impairment Test

It is important for companies to know that a goodwill impairment test does not need to be performed every year if reporting units meet certain standards in ASC 350. As detailed in ASC 350, formerly SFAS 142, goodwill impairment testing is imperative for all companies that have goodwill balances. In a goodwill impairment test, the Fair Value of a company's reporting units are analyzed. If the Fair Value of the reporting unit is greater than the Carrying Amount of the reporting unit, there is no impairment loss. However, if the Carrying Amount is greater than the Fair Value, the company needs to perform an impairment test.

Usually goodwill impairment testing should be performed annually, but it may be performed at any time during the year. For consistency, the FASB recommends the test

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## “Section 409A...” continued from p. 1

- Terms for deferral elections and any relevant deadlines for making such elections;
- Terms for subsequent deferral elections (i.e., changes to prior deferral elections), including the original payment date and the rescheduled payment date;
- Any acceleration in payment made before the originally scheduled payment date, including due to elections made under available transition relief and the deadlines for such elections; identification of the original payment date and the actual payment date;
- The names of “specified employees” in public companies and the period during which such individuals were specified employees;
- Payments of nonqualified deferred compensation made during the applicable year to specified employees upon separation from service, and whether such payments were made within six months after the date of separation from service;
- Certain information on stock rights that may be subject to Section 409A;
- The funding of deferred compensation as a result of any event that relates to a decline in the company’s financial condition; and
- Any violations of Section 409A and whether the company participated in the Section 409A corrections program.

Section 409A provides that a nonqualified deferred compensation plan must comply with various rules regarding the timing of deferrals and distributions. Non-compliance results in severe penalties for employees receiving the deferred compensation. The penalty for non-compliance immediately taxes all amounts deferred under the plan, plus a 20% penalty tax, to the extent the compensation has not been previously included in gross income.

The IRS provides two compliance options for companies granting stock options under Section 409A:

1. Have a person, internal to the company, who has “significant knowledge and experience or training in performing similar valuations,” prepare a written

valuation report detailing the accurate pricing of the common stock.

2. Hire an independent, qualified and experienced valuation firm to prepare a written valuation report.

Section 409A requires companies to complete a formal valuation to price their common stock. By completing a formal business valuation, the IRS has the burden of proof to show that the price of the common stock is unreasonable. ♦

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## “When to Roll Forward...” continued from p. 1

be performed at the same time each year. Additionally, different reporting units may be tested at different times during the year, regardless of the fiscal year of the parent company. Companies should consider the criteria below before deciding whether or not to perform an annual goodwill test:

- Whether or not the reporting unit’s assets and liabilities have changed significantly since the last goodwill impairment test. A significant event or change that would affect Fair Value of the reporting unit would include an acquisition or reorganization of the reporting unit’s structure.
- Whether or not the recent Fair Value determination exceeded the reporting unit’s Carrying Amount by a substantial margin.
- Whether or not a current Fair Value determination would be less than the Carrying Amount.

Each of these three criteria needs to be met for the Fair Value of a reporting unit to be carried forward into the next year, therefore exempting a goodwill impairment test. Goodwill impairment testing engagements can range from full-scope, detailed business valuations to shorter letters addressing the above criteria. It is important to coordinate the scope of the engagement between the valuation firm and the auditors to ensure compliance with US GAAP. ♦

## Spotlight on Court Cases

### ***King. v. King, 2009 WL 2475214 (Ky. App.) (Aug. 14, 2009) (discretionary review den'd by Ky. Supreme Court, March 10, 2010)***

In this case the value of the husband's solo OB/GYN practice was thoroughly litigated by the two parties. The wife's expert looked at nationwide compensation data and determined what a doctor with the husband's experience, expertise, education, and age could earn in the parties' geographic area. The wife's expert used a capitalization of earnings method to determine the value of the husband's medical practice at \$1,013,000, including \$797,841 of goodwill. The expert did not distinguish between the components of goodwill.

The husband's expert relied on data provided by a local OB/GYN, referred to as the "Peer Doctor." The area had a shortage of OB/GYNs, and according to the expert, worked 15% more hours than the Peer Doctor. The expert adjusted the husband's annual earnings, which were greater than \$700,000, by \$214,000 (extra hours worked). The expert valued the practice at \$636,000.

The trial court adopted the valuation by the wife's expert and the husband appealed. The husband claimed that his expert's valuation was superior because it reflected his excess hours and the area's shortage of doctors. The Kentucky Court of appeals agreed with the husband. The court also cited the "new rule" in Gaskill, and noted that courts should consider the distinction between personal and enterprise goodwill.

In this case, neither expert distinguished the components of goodwill (personal or enterprise). In addition, both experts testified that the husband's higher compensation resulted from his work ethic and dedication (personal goodwill). The court held that any value of the husband's practice that was due to personal goodwill, work hours that were in excess of the norm, should be excluded when valuing the practice.

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### ***IP Innovation, LLC v. Red Hat, Inc., 2010 WL 986620 (E.D. Tex.) (March 2, 2010)***

The plaintiffs patented a workspace switching feature and then accused the defendants of using it in their operating systems. The plaintiffs did not manufacture or sell the products with its patents, and retained an expert to calculate damages based on a reasonable royalty rate.

The expert used the "entire market value rule" to calculate a royalty base. Under the "entire market value rule," the damages are only recoverable if the patents are so crucial to the software that they are the main reason for consumers purchasing the product. The plaintiff's expert used all revenues from sales of subscriptions of the defendant's operating system that contained the workspace switching feature to calculate the royalty rate base.

The U.S. District Court noted the following:

- The workspace switching feature only represented one of thousands of components in the operating system product.
- The plaintiff's expert relied on selected user statements from an online forum in isolation to support the "entire market value rule."
- The plaintiff's expert failed to consider the relative importance of other operating system features, including security, interoperability, and virtualization.

In addition, most of the defendant's sales come from its server products, which do not have displays and could not use the patented workspace switching feature. Also, some of the operating systems have a default setting that disable the feature.

Because the expert failed to consider these major items, provided little support for the royalty rate base, and royalty rates, the court stated that the expert's analysis had shown, "inattention to the economic and factual data necessary for a reliable assessment of a compensatory royalty." The defendants moved to strike the expert and his report under Rule 702 and the Daubert standard.

This case highlights the lack of diligence on part of the plaintiff's expert to understand the defendant's operating system and provide evidence for the workspace switching feature's consumer value to support his use of the "entire market value rule."

## Practice Highlights

In June, The McLean Group's Brian Sullivan hosted a panel discussion with Merrill Lynch and Jones Day entitled *Keep Your Eye On Your Business, But Know Where The Exits Are!* in San Francisco.

The discussion addressed the effects of recent market changes on capital and funding sources and provided insights from financial, tax and legal experts on how to prepare a company for potential sale. Additionally, the panel discussed current private company valuations and how potential changes in capital gain taxes may impact those valuations.



## The McLean Valuation Services Group Offices

**The McLean Group is a national middle market investment bank providing mergers & acquisitions (M&A), business valuation and market intelligence services in more than 30 cities in the U.S. and Canada.** Its affiliate, The McLean Valuation Services Group, performs business valuations for transaction, financial reporting, and tax purposes. The McLean Valuations Services Group has dedicated business valuation offices in the following locations:

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