

Advocate's Edge

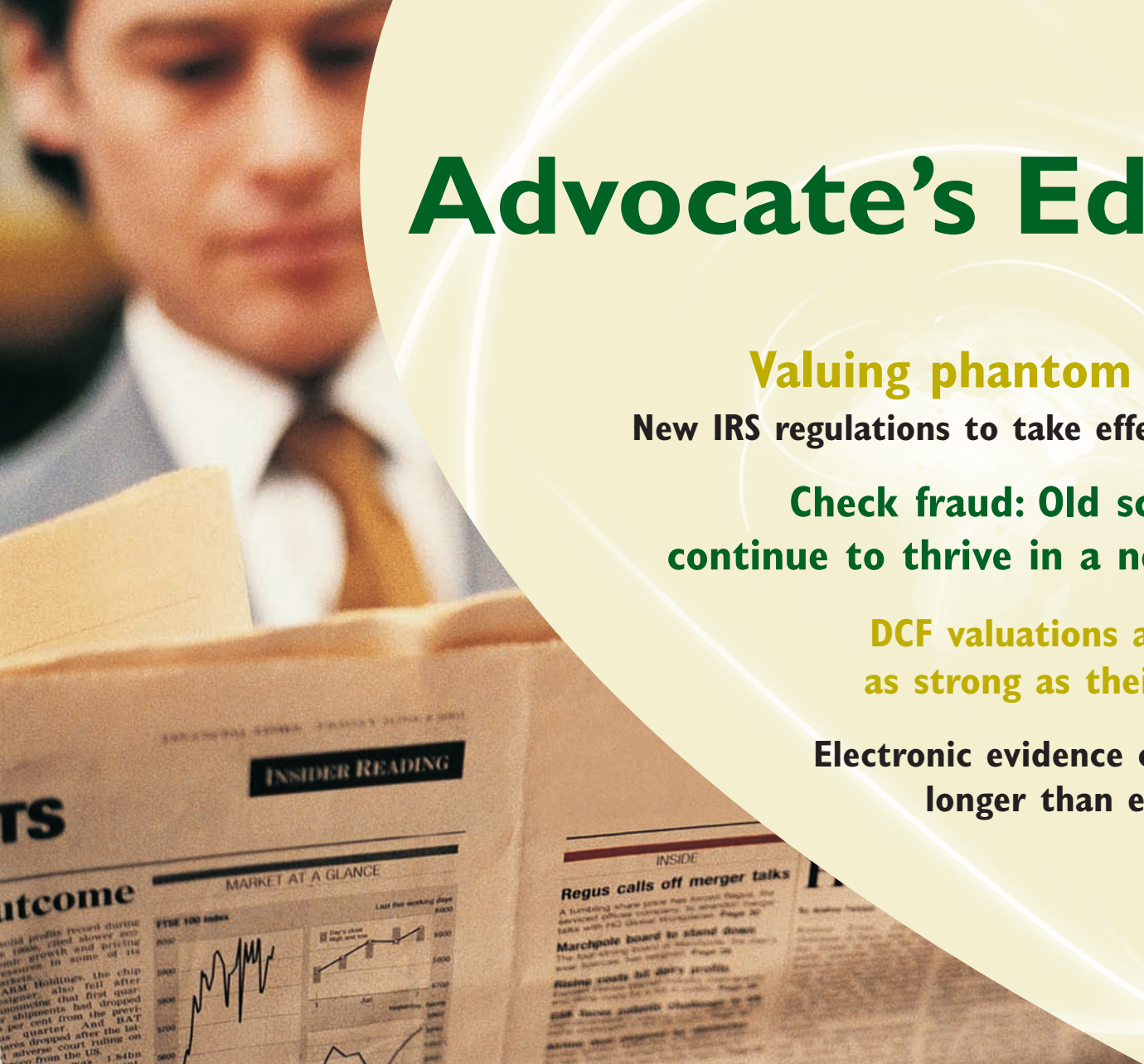
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Companies, particularly closely held ones, increasingly are offering employees phantom stock. Phantom stock gives an employee a greater stake in company performance without ceding actual ownership. But the arrangements raise some issues related to valuation, especially under new IRS regulations.

Rewards employees, benefits owners

Phantom stock is a type of deferred compensation used to recruit and retain key employees and motivate them to help build a company's value. Generally, a phantom stock plan creates deferred compensation units and assigns a base value equal to the value of the company's common stock.

Phantom shares are similar to stock options, but employees don't purchase company shares or possess equity or shareholder rights. Rather, they're granted phantom shares under a vesting schedule and reap the increase in value over the initial value.

Payouts are required to be made in a set number of years or upon a triggering event — for example, retirement, a change in the company's controlling ownership or the employee reaching a specific age. Employees aren't taxed until they receive a payment, and the company deducts the payment in the year it is made.

Phantom stock programs are particularly attractive for companies with restrictions on ownership, such as sole proprietorships, partnerships or S corporations, because they don't affect the allocation of ownership. Even companies without ownership restrictions might use phantom stock to retain full equity while

incenting employees. And phantom stock plans typically are less expensive to administer than traditional employee ownership plans.

Companies considering a phantom stock plan also should be aware of the caveats. For example, when phantom stock payments are made to employees, payments dilute the existing shareholders' equity value.

Valuing shares

The value of phantom shares is based on changes in the value of the issuing company. Value must be recorded on the books at the time the stock is credited — with annual adjustments made to reflect changes in the value of the company's equity. Expert valuation is, therefore, critical to managing a phantom stock plan.

Valuation must account for certain risks intrinsic to phantom stock. Because they may be tied to a

FAIR MARKET VALUE FACTORS

Final regulations under Section 409A of the Internal Revenue Code list several factors to be considered in determining a private company's fair market value (FMV). These include:

- ✓ The value of a company's tangible and intangible assets,
- ✓ The present value of anticipated future cash flows,
- ✓ The market value of stock or equity interests in similar companies and other entities engaged in substantially similar business,
- ✓ Recent arm's length transactions involving the sale or transfer of such stock or equity interests, and
- ✓ Other relevant factors, such as control premiums or minority discounts and whether the valuation method is used for other purposes having a material economic effect on the company, its stockholders, or its creditors.

FMV previously calculated isn't reasonable if the value was calculated for a date more than 12 months before the date for which the current valuation is being used. It also isn't reasonable if it fails to reflect information available after its calculation that may materially affect the company's value, such as the resolution of material litigation or issuance of a patent.

period of time or triggering event that may not occur, phantom shares carry a risk that common shares don't. What's more, phantom stock may come with an "option price," meaning an employee receives only an amount above a pre-established level.

IRS regulations

To provide potential tax benefits, phantom stock must satisfy IRS regulations issued this past May regarding nonqualified deferred compensation plans.

Section 409A of the Internal Revenue Code (IRC) provides that, unless certain requirements are met, deferred compensation for all taxable years currently is includible in an employee's taxable gross income to the extent it's not subject to a substantial risk of forfeiture and not previously included. If these requirements aren't fulfilled, the employee must pay taxes on the deferred amounts, an additional 20% penalty tax and interest.

Companies with covered plans — which include phantom stock plans — need to value their stock to determine if the plan is exempt from Sec. 409A. To be exempt, the exercise price of the stock right conveyed can't be less than the fair market value (FMV) of the underlying stock on the grant date.

The 409A regulations provide guidance on the valuation of both public and private company stock. For public companies, the FMV can be based on:

- ✓ The last sale before or the first sale after the grant,
- ✓ The closing price on the trading day before or the trading day of the grant,
- ✓ The mean of the high and low prices on the trading day before or the trading day of the grant, or
- ✓ Any other reasonable basis using actual transactions in such stock and consistently applied.

Public companies also can determine FMV by using the average selling price over a specified period



within 30 days before or after the date of the grant. This method is acceptable only if the commitment to grant the stock right is irrevocable before the measurement period and the valuation method is used consistently for other grants.

Private companies must determine FMV by a "reasonable valuation method" that considers all available material information. The regulations describe three methods presumed to produce a reasonable valuation: 1) an independent appraisal, as of a date no more than a year before the grant date, that meets certain IRC requirements; 2) a valuation based on a formula that doesn't lapse over time, if consistently used for all valuations of stock, including transactions involving the issuance or repurchase of stock by the company or anyone who owns more than 10% of the total voting power; or 3) for the illiquid stock of a startup company in business for fewer than 10 years, a valuation made reasonably and in good faith and satisfying certain requirements.

Sense of urgency

These new IRS regulations take effect Jan. 1, 2008. All phantom stock plans — along with any other covered deferred compensation plans — should be reviewed by then to allow time to remedy any problems and avoid premature taxation. Corporate clients may well require your guidance on how to structure their plans properly to satisfy Sec. 409A. ✧

Check fraud: Old schemes continue to thrive in a new age

Check fraud has probably been around since checking accounts were created, but the Internet and other technological developments have provided it with new opportunities to flourish. Considering that businesses are likely to be held liable for at least part of related losses, it pays to understand how these schemes work and how they can be prevented.

Continuing popularity

Check fraud placed third on the 2006 Internet Crime Report released by the FBI and the National White Collar Crime Center. Even though online check fraud is relatively new, the basic methods haven't changed much over the years. Most fall into one of the following categories:

Forgery. An employee issues an employer's check without authorization, or a perpetrator cashes or writes stolen checks.

Altered checks. A fraudster alters or erases the information on a legitimate check, often through the use of bleaching agents. Then the perpetrator enters new information — including amounts and payees — by typing, printing or handwriting.



Counterfeiting. In the past, counterfeit checks were created with photocopiers. Now, counterfeiters use desktop publishing to produce fake checks drawn on valid accounts.

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Identity theft. A perpetrator obtains information about a financial institution's customer — name, address, employer, account number or Social Security number — and uses it to assume the customer's identity and access his or her funds.

Closed account fraud. The thief writes checks on a closed account, relying on the “float” time between financial institutions. Also known as paperhanging, the scheme resembles check kiting, whereby perpetrators write checks against accounts that lack sufficient funds, deposit them in another account, and then withdraw funds from the second account.

UCC equitably assigns liability

Check fraud falls under Article 3, *Negotiable Instruments*, and Article 4, *Bank Deposits and Collections*, of the Uniform Commercial Code. The UCC attempts to equitably assign liability among the involved parties, which could include the drawer, payee, drawee bank and depository bank.

A fraudster can enter at any point in the process as a check travels among these parties. Legal claims, however, usually are brought against the drawee bank that paid a check with a forged signature or the depository bank that accepted and processed a check with a forged payee endorsement.

CPAs lend a hand

Since the advent of the Check Clearing for the 21st Century Act in 2004, banks have been permitted to rely on electronic or paper copies of checks during the clearing processing, rather than the original checks. As a result, check fraud has become even trickier to detect, particularly forgeries and alterations. Fortunately, forensic accountants can help detect check fraud early and possibly avert litigation. Forensic accountants generally begin by looking for certain red flags, including:

- ✓ No watermark,
- ✓ Stains or discolorations,
- ✓ Print that isn't uniform in color and texture,
- ✓ Missing magnetic ink character recognition coding on the bottom of the check, or shiny rather than nonglossy ink,
- ✓ A missing check number under the signature line,
- ✓ A mismatch between the 9-digit routing number on the bottom of the check and the two sets of numbers on the upper right corner,

- ✓ A low check number, indicating the account was recently opened, and
- ✓ No address for the customer or bank.

If any of these characteristics are observed, further investigation may be warranted. This could include interviews with employees and tracing of the check's origin.

Where original checks are available, the forensic accountant also can provide valuable testimony explaining the implications of pen pressure, fingerprints and similar evidence. And, in any case, an expert can testify about technological methods of alteration and forgery. Finally, forensic experts can help companies put in place internal controls that prevent check fraud from happening again.

Pay it forward

When you or your clients suspect they've fallen victim to check fraud, a forensic accountant can help you pinpoint where the fraudster entered the process and, in turn, determine liability. With luck, you can avert or at least minimize the damage. ✨

DCF valuations are only as strong as their input

When appraising a business, professional valuers often use a method known as discounted cash flow (DCF). The method can be based on future cash flows to a company's equity or to its total capital. Regardless of the DCF approach used, however, the results are only as strong as the input at each step of the process.

Forecasting future benefits

The DCF method involves three major steps. First, the valuator projects the company's expected earnings or cash flow for the number of financial periods necessary to obtain a stabilized earnings stream — typically three to 10 years. Projections are tested by



conducting market analysis that considers whether the projected growth is reasonably achievable in light of the company's ability to develop new products or services, the overall market size, and competition within that market.

Assumptions used to build the forecast can greatly influence the results and must, therefore,



be reasonable. The valuator also must be able to explain any differences between historical performance and projected performance.

Determining terminal value

Next, the valuator determines the terminal value by calculating the company's capitalized earnings at the end of the forecast period. A valuator can capitalize earnings in several ways, including with a single-period earnings capitalization or by applying market multiples derived from guideline companies.

Alternatively, the expert can apply multiples developed using the capital asset pricing model (CAPM) or the weighted average cost of capital (WACC). Under the CAPM, the cost of capital equals the appropriate risk-free rate of return added to a risk premium that reflects the market risk. The WACC is a weighted average based on the market value of the cost of debt, equity, preferred stock and other capital structure components.

Selecting a discount rate

Finally, the valuator selects a discount rate — often the cost of capital — to reduce the forecasted future cash flows and terminal value to present value. The discount rate is the rate of return that an investor would require given the risk associated with that investment. The appropriate rate depends on whether the valuator is using an equity method, which forecasts only the earnings available to equity holders, or a total capital method, which forecasts the earnings available to all capital providers.

Some valutors using equity methods develop the discount rate using the CAPM and others use an adjusted CAPM. Valutors using an equity method also might diverge when applying the discount rate to net income or to net cash flow.

When using total capital methods — which look at either debt-free net cash flow or debt-free net income — a valuator is likely to apply a WACC as the discount rate. The WACC generally uses market value weightings of equity and debt, rather than book value.

The valuator must be able to explain any differences between historical performance and projected performance.

Back to the present

The very definition of value is exactly what the DCF method accomplishes. Value is defined as a company's future earnings (cash flows) discounted to present value using a discount rate that is equivalent to the rate of return that an investor would require given the risk associated with that investment.

When applying DCF to reach a company's present value, seemingly minor variations in assumptions about the timing of compounding or capitalization can make a dramatic difference in the final result. Experienced valutors will state their assumptions clearly and explain why they are reasonable given the company's circumstances. ✧

Electronic evidence can lurk longer than expected

As reflected by the 2006 amendments to the Federal Rules of Civil Procedure, electronic evidence is taking a more prominent role in all types of litigation. Documents and e-mails are obvious sources of evidence, but there is likely to be valuable data in places you might not have considered.

When deleted files aren't

You've probably heard that electronic files are never truly deleted. That might be a bit of an overstatement, but e-files tend to linger — if not in whole, then at least in pieces. When someone deletes a document, for example, the data associated with that document remains on the hard drive until it's overwritten.

Forensic experts may be able to find remnants and reconstruct original documents. Several factors affect the likelihood of reconstruction, including time elapsed since deletion, activation of file destruction or wiping software and the size of the hard drive. The greater the time lag and the smaller the drive, the more likely data is no longer accessible.

A computer's virtual recycle bin can help an expert determine which files have been deleted and when.

Other sources

Forensic experts look to several other sources for electronic evidence:

Recycle bin. A computer's virtual recycle bin can help an expert determine which files have been deleted and when. Emptying the bin makes the data inaccessible for the average user, but an expert can



scan a drive for discarded bin data. Further, a hidden file located in the bin holds deleted file stamps that can indicate when the respective file was deleted. Although the file is cleared when the bin is emptied, it may be possible to recover the file's contents.

Cache. Temporary Internet files, or caches, are created whenever a browser opens a Web page. Many users never clean their caches, but even if they do, experts can ferret out information and create a road map of where the user has been online.

File slack. Computers generally store files in data blocks. Blocks rarely are the exact size of a file, leaving space or slack. Computers fill that slack with random data from their memory or pieces of deleted files, which can hold a gold mine of evidence.

Experts also find evidence in embedded data, Internet history logs and "cookies." The accessibility of evidence and appropriate methods of extracting it vary by computer operating system.

Brave new world

Today's computer-driven world offers a potential wealth of evidence to those who know where to look. Forensic experts can help you and your clients navigate these often complicated sources of data. ✧

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