cogent valuation

VALUATION CASE

IRC 108 - Insolvency in connection with Discounted Debt Repurchase

The repurchase and forgiveness of public debt issues trading below face value would have caused the issuer to report income equal to the difference between the face value and the purchase price. However, in accordance with IRC 108, entities that can show insolvency equal to or greater than the income at the time of repurchase are not required to recognize such income.

Scope of the Assignment

Cogent Valuation was retained to value certain intangible assets and opine to the amount of the insolvency, if any, of a telecommunications company. The client, a provider of wholesale and retail integrated communications services, was a publicly traded company with uncertain growth potential because of the nature of its service offering.

A majority of the Company's clients operated in an industry sector that was experiencing technology obsolescence. Moreover, the Company's ability to collect receivables was uncertain. During the fiscal year the Company had consummated three tranches of debt repurchases and subsequent retirement. The debt had been repurchased at a 65% discount to its face value.

The poor operating performance of the Company, the large upcoming principal repayment of the public debt, the substantial operating and financial risk of the telecommunications industry, and the Company's significant financial risks are factors that the bondholders considered in accepting the deeply discounted repurchase price.

IRC Section 108

Section 108(a)(1)(B) provides that the income from the discharge of indebtedness may be excluded from gross income for income tax purposes if the discharge occurs when the taxpayer is insolvent. Furthermore, Section 108(a)(3) provides that the exclusion of debt forgiveness income from gross income is not to exceed the amount by which the debtor is insolvent prior to the debt forgiveness event.

IRC 108 defines insolvency as the excess of the liabilities over the fair market value of the assets determined immediately before the discharge of indebtedness.

Previous Experience

Cogent Valuation has significant experience in the telecommunications industry including assignments related to tax, litigation and investments. Cogent Valuation was well suited to value the intangible assets of the client including reciprocal compensation from ILECs, a fiber optic indefeasible right of use (IRU), and capitalized software.

Valuation Analysis

Cogent Valuation's assignment was limited to a balance sheet test analysis, which determines an entity's solvency [insolvency] as the extent by which the fair market value of its assets exceeds [lags] its liabilities. The appropriate valuation methodology for the solvency analysis was therefore the asset approach, which is used to simulate an orderly liquidation of a Company's assets and payment of its liabilities.

Cogent Valuation first determined the fair market value of each of the client's individual assets if sold in an orderly manner, assuming a reasonable time to expose the assets to the market to achieve the best available price. We used the Company's balance sheet and adjusted the book value of the assets to reflect their pre-transaction fair market values.

In particular, Cogent Valuation researched and identified off-balance sheet assets that would not have been recognized for reporting purposes but could have material value in the liquidation process.

Definitions

ILEC is the abbreviation for Incumbent Local Exchange Carrier, which refers to the existing entities that operated in the telecommunications industry prior to the Act. ILECs include the former Bell operating companies.

CLEC is Competitive Locale Exchange Carrier, which refers to the new companies that entered the telecommunications industry after the deregulation and the enactment of the Act.

Reciprocal Compensation is the practice by two telephone companies to share the fees collected for a phone call that was initiated in one phone company's area/switch and terminated in the other phone company's area/switch. As an example, if an ILEC customer makes a local call to a CLEC customer, the ILEC would collect the entire charge for the call, but would in turn pay the CLEC a portion of the collected fees.

Reciprocal Compensation

The analysis incorporated the value of the reciprocal compensation arrangements from ILECs with whom the client had interconnect agreements. Because ILECs frequently dispute bills received from other telecommunication companies and typically pay only a portion of the amount owed in one payment made approximately two weeks after the billing date, the

About the Firm

Cogent Valuation is a nationally recognized firm that has provided independent valuation and financial advisory opinions in thousands of situations since 1991. Cogent Valuation utilizes proprietary research, intensive due diligence, and the experience and insights of its professionals to produce thoughtful, well-documented opinions that have consistently withstood the scrutiny of clients and their advisors, investors, regulators, and courts.

Company treats the unpaid portion as bad debt. The client's experience has shown that litigation is typically the only solution for collection of most of the unpaid bills. We concluded that a historical analysis of collection rates would provide the most accurate depiction of the fair market value of the Company's various reciprocal compensation receivables.

Fiber IRU

The Company had an indefeasible right of use agreement for dedicated fiber optic capacity connecting ten major metropolitan areas in California. Cogent Valuation utilized an income approach to value the right. We determined the expected representative monthly fee for the IRU, based on the wholesale market rates for each of the ten metropolitan areas. These discrete income streams were projected to continue uninterrupted through the end of the IRU contract term in June 2020.

Capitalized Software

The Company held capitalized software with a substantial original cost. This asset class included various types of applications, including in-house developed and customized applications and e-business software. Cogent Valuation conducted extensive research that included discussions with several professionals specialized in the valuation and/or purchase and sale of used software. In the final determination of value for this asset class the poor quality of the Company's records regarding their software, the dominance of highly customized applications and capitalized consulting service fees, and the transfer restrictions attached to their e-business software suite were all factors that were taken into account.

Liabilities

The Company's liabilities consisted of current liabilities, an IRU obligation, restructuring charges, and notes payable.

The restructuring charges pertained to the closure of facilities in two neighboring states. The reserve includes rent expense for vacated premises, circuit obligations, and other charges. Cogent Valuation estimated that these three charges were actual liabilities of the Company and did not apply any adjustment.

Each individual liability was valued. For a majority of the liabilities, the book value was assumed to represent the appropriate value to determine the solvency of the client for purposes of IRC 108.

Conclusion

In determining the client's solvency condition, Cogent Valuation performed a balance sheet test, where the fair market values of the Company's assets were compared to the book values of its liabilities. In this case, the fair market value of the Company's liabilities far exceeded the fair market value of its assets, and Cogent Valuation concluded that the client was insolvent as of the date of valuation.

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Ms. Reinemann is a Managing Director with the San Francisco office of Cogent Valuation. Ms. Reinemann has over 13 years of valuation experience that includes the valuation of early stage high-tech and life-science companies in areas such as securities design, license valuations, mergers and acquisitions, pre-IPO valuation, equity allocation, and options pricing. Her project experience encompasses issuance of opinions regarding fairness, solvency, due diligence, and intellectual property. Ms. Reinemann holds the Chartered Financial Analyst designation and she is an Accredited Senior Appraiser of the American Society of Appraisers.

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