

# Insight

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## Valuation Integral to Sec. 409A Requirements

Since the issuance of Section 409A in 2005, private companies at all stages of development are obtaining independent valuations to support option grants for tax purposes. It is important for companies to understand and consider the impact of Section 409A on their tax planning.

Section 409A applies to any plan or arrangement under which a service provider has a legal binding right to compensation that is or may be payable to the service provider in a later taxable year, for example, a bonus earned in 2009 but paid in a later year. Section 409A is broad-based and applies to many compensation plans which are usually not considered to be deferred compensation.

While an independent appraisal of shares is not required for private company stock valuations, many companies choose to obtain an independent valuation, which provides a “safe harbor” under Section 409A.

## DUAL PURPOSE VALUATION

A valuation report that provides the fair market value of the common stock to satisfy Section 409A can also provide the fair market value of the common stock to satisfy financial reporting requirements. This “dual purpose” valuation will provide consistency between book and tax accounting treatment, and will ensure that the company does not have to obtain a second valuation to satisfy its auditors. We adhere to the allocation methods proscribed in the AICPA Practice Aid, *Valuation of Privately-Held Company Equity Securities Issued as Compensation* (the “Practice Aid”).

The valuation will generally not be accepted for financial reporting purposes if it does not comply with the methodologies outlined in the Practice Aid. On the other hand, the tax guidance is less specific. To our knowledge there is no valuation methodology or guidance comparable to that contained in the Practice Aid. Section 409A, however, mandates that the valuation be completed using reasonable valuation methods and that the valuation professional has proper experience and training.

We have found that the allocation methods recommended in the Practice Aid tend to produce a higher common stock valuation than other methods which may be acceptable for tax purposes. Consequently, we have been asked by potential clients to employ the methods that will produce the lowest common stock valuation since the valuation will be used for tax purposes only. We contend that the valuation of a development-stage company’s common stock is best estimated using the methods in the Practice Aid, regardless of the purpose of the valuation, and therefore, that it is inappropriate to apply different methods for book and tax.

## CASE STUDIES

1) Our client (the “Acquirer”), a privately-held professional employer organization (PEO), originally engaged VRC to provide common stock valuations for Section 409A purposes and for SFAS 123R purposes. This work led to VRC being engaged by a special committee of the Acquirer’s board of directors concerning the impact of a proposed acquisition of a publicly-traded competitor on the

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value of common stock held by the Acquirer's minority shareholders.

The transaction was complex because the acquisition was funded with new bank debt and new convertible preferred stock issued to the controlling shareholder (a private equity firm). Both the economics of the combined entity valuation and the issuance of new debt and equity had potential value ramifications for the minority shareholders holding common shares.

The Acquirer's board formed a special committee of independent directors to ensure that the transaction was fair to the company's minority shareholders. We were asked to perform an analysis that would demonstrate that the minority shareholders were no worse off as a result of the transaction. It was determined that this could be demonstrated by comparing the value of the common stock before and after the acquisition.

Valuing the common stock before the transaction involved establishing the stand-alone value of the Acquirer's common stock on a pre-acquisition basis and then allocating that value across the existing capital structure, which included debt, a layer of convertible preferred stock, common stock and stock options. Valuing the common stock after the transaction involved establishing the value of the pro forma combined entity, including synergies, and then allocating that value to the pro forma capital structure, which included new debt, two layers of preferred stock, common stock and stock options.

2) VRC was engaged by a medical device company to value its common stock for Section 409A and SFAS 123R purposes. The company had a complex capital structure with Series A through Series E convertible preferred stock, with several of the series having participation caps. VRC valued the company using traditional valuation methodologies including a discounted cash flow analysis, comparable public company analysis and comparable acquisitions analysis. The enterprise value was allocated to the various securities comprising the capital structure of the company using the Option Pricing Method outlined in the AICPA Practice Aid. VRC's work was reviewed by a Big 4 audit firm.

Given our intimate understanding of the Company's capital structure resulting from the Section 409A/SFAS 123R valuation worked performed, we were engaged by Company management on a consulting basis to determine the proceeds the various types of shareholders would receive under different liquidity event scenarios. This work provided support to the company's CFO with respect to various preliminary offers the company has received to purchase the company.

Valuations for Sec. 409A are complex. We recommend hiring a valuation firm familiar with the methodologies described in the Practice Aid. If the firm is unfamiliar with the Practice Aid, it is unlikely that the valuation will satisfy a company's auditors. For more information, contact your Valuation Research representative or Justin Johnson at (415) 277-1803. **VR**

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