

# Alert

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## Avoid Paying a High Price for Cheap Stock

*“One of the most significant contributions of this Practice Aid is to provide management of IPO candidates a hierarchy of valuation alternatives.”*

With the continuing recovery of the IPO market, IPO candidates should make sure they have adequately addressed the "cheap stock" issue. Cheap stock refers to issuance of an equity security (e.g., options, warrants, common stock or restricted stock) during the 12 months preceding an IPO for a price (or with a strike price) that is below the expected IPO price. Typically this issue arises in connection with the granting of employee stock options. IPO candidates that issue securities in exchange for employee services must be careful that they comply with the rules in APB 25 or SFAS 123.<sup>1</sup> A particular concern of the SEC during the IPO registration process has been the adequacy of valuations supporting the strike price of employee options (one of the key inputs in determining the intrinsic value of options under APB 25 or the fair value of option under SFAS 123). Deficiencies in the reliability, reasonableness, or supportability of the valuation could result in the need to record a "cheap stock" charge and possibly also to restate the financial statements.

### VRC NEWS

VRC will be presenting a webcast, "Valuing Privately-Held-Company Equity Securities," on June 22, 2004 at 1:00 CST. Register at [www.valuationresearch.com/registration.htm](http://www.valuationresearch.com/registration.htm).

### HIERARCHY OF VALUATION ALTERNATIVES

What can IPO candidates do to avoid a cheap stock charge and the possible restatement of their financial statements during the registration process? The AICPA has tried to answer this question in a recently published Practice Aid: "Valuation of Privately-Held-Company Equity Securities Issued as Compensation." The short answer is: Support each option grant by obtaining a *contemporaneous* valuation of the company's common shares by an *independent* valuation specialist. One of the most significant contributions of this Practice Aid is to provide management of IPO candidates a hierarchy of valuation alternatives. The highest level in the hierarchy is fair value as determined in a contemporaneous valuation by an independent valuation specialist. The next best alternative is fair value as determined in a retrospective valuation by an independent valuation specialist. The lowest level is fair value as determined in a contemporaneous or retrospective valuation by a nonindependent valuation specialist.

The hierarchy contains no provision for "rule of thumb" discounts. With regard to such rule of thumb discounts the Practice Aid contains the following statement:

*Historically, many privately held enterprises, especially early-stage enterprises, have used general "rule of thumb" discounts on determining the fair value of common stock, such as determining the value as a specified percentage of the price of the most recent round of preferred stock or at a discount to the anticipated IPO price for an enterprise actively considering an IPO. Although the fair value of privately issued securities of an enterprise considering an IPO may be less than the ultimate offering price, such "rule of thumb" discounts are inappropriate because they are difficult to substantiate objectively and do not result in a high-quality determination of value.*

<sup>1</sup> Note that the FASB's current Exposure Draft on share-based payment will likely amend FASB Statements Nos. 123 and 95.

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*“Companies may run into problems with the SEC during the registration process if the valuation is nonindependent...”*

Companies may run into problems with the SEC during the registration process if the valuation is nonindependent, has been performed on a retrospective basis, or is unreasonably low as compared to the expected IPO price or the price of a recent financing. The Practice Aid recommends that financial statements included in registration for an IPO disclose, among other things, the following information for equity instruments granted prior to the date of the financial statements: (i) the fair value of the common stock, (ii) whether the valuation used to determine the fair value of the equity instruments was contemporaneous or retrospective and (iii) if the valuation was not independent, a statement of that fact.

### BEST PRACTICES

The Practice Aid also provides recommendations for best practices to use in determining the fair value of the common stock of privately held companies. The GAAP hierarchy for determining fair value is referenced. Under the GAAP hierarchy, prices in active markets provide the best evidence of fair value. If quoted market prices are not available, fair value should be based on the best information available, including prices of similar securities and the results of using other valuation techniques.

Since privately-held securities are by definition not traded, basing fair value on quoted market prices is not possible. A recent arm's-length transaction in a company's stock with an independent party may be the next best indication of value. However, it is often not the company's common stock that is the subject of such a transaction, but convertible preferred stock, which may be difficult to compare to the common stock due to its unique rights, privileges and preferences. Nonetheless, in cases where there has been a recent round of preferred financing, the valuation specialist may derive the value of the company's common stock by deducting the value of the primary features of the preferred stock that distinguish it from the common stock. Experts at Valuation Research have developed a proprietary model designed to value common stock in this manner. Of course this approach can only be applied when there is a recent transaction in the preferred stock of the company.

In cases where higher sources of valuation evidence are not available, traditional valuation methods should be applied including the cost, income and market approaches. The Practice Aid provides a useful framework for determining which approaches work best at various stages of development of the enterprise. It is important to note that these methods are used to first establish the enterprise value of the business. The valuation specialist must then determine how the enterprise value as a whole should be distributed among the various equity claimants. For more information regarding valuation of privately-held-company equity securities, contact your Valuation Research representative or Justin Johnson at (415) 277-1803. **VR**

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