

Alert

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Valuation for Sec. 409A Purposes Can Also Satisfy Financial Reporting Requirements

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Previously, only private companies that were serious IPO candidates worried about valuing their common stock. These companies obtained a valuation to avoid a "cheap stock" issue with the SEC when filing an S-1. As a result of Section 409A, which took effect in 2005, private companies at all stages of development are now obtaining independent valuations to support option grants for tax purposes, not just IPO candidates. Even companies that are at a very early stage of development are seeking independent valuations in setting the strike price of employee stock options.

Auditors are cognizant of this development and since the granting of stock options is also a financial reporting issue, they will want to know how the company established the strike price of its options. If the company relied on an independent valuation, its auditors will want to see the valuation report. Our valuations frequently end up in the hands of a company's auditors even if the valuation was originally obtained for tax purposes.

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 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 recommend using the same valuation and allocation methods for both purposes. 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 new methodologies outlined in the Practice Aid. The tax guidance is less specific. To our knowledge there is no proscribed valuation methodology or guidance comparable to that contained in the Practice Aid. Section 409A, however, mandates that the valuation be done using reasonable valuation methods and that the valuation professional has the 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.

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VALUATION PROCESS

Valuation of development-stage companies is one of the most challenging assignments due to the wide range of potential valuation outcomes. Moreover, the industries these companies compete in, such as the technology, life sciences and other high growth industries, are specialized and complex.

“If the (valuation) firm is unfamiliar with the Practice Aid, it is unlikely that the valuation will satisfy a company's auditors.”

Despite the complexities, the valuation process can generally be broken down into two basic steps. The first step is to establish the total equity value of the company. The second step is an allocation of the total equity value to the various equity securities that comprise the company's capital structure.

The Practice Aid provides little guidance concerning the first step, other than which methods to apply at what stages of development, and that the valuation is best obtained contemporaneously as opposed to retrospectively. In establishing the total equity value of an enterprise, the analyst will typically use as many of the generally accepted valuation methods and techniques as possible. We use the following methods to establish the equity value of the company: (i) comparable public company analysis, (ii) comparable acquisitions analysis, (iii) comparable private company financings analysis, and (iv) discounted cash flow analysis. For very early-stage companies, we often consider a cost or asset-based valuation approach.

ALLOCATION METHODS

Undoubtedly the greatest contribution of the Practice Aid concerns allocation methods and not valuation methods. An allocation of the total equity value to the various securities that comprise the company's capital structure is typically completed using one of three generally accepted methods: (i) the current value method, (ii) the option-pricing method or (iii) the probability-weighted return method.

Use of the current value method is only accepted when liquidity is imminent or when the company is at a very early stage of development. If liquidity is not imminent, either the option-pricing method or the probability-weighted return method is recommended. There is no requirement that both methods be used. The option-pricing method may be more suitable for earlier-stage companies when the timing and valuation surrounding a future liquidity event is less defined. Both the option-pricing method and the probability-weighted return method tend to produce higher common stock valuations than the current value method.

Valuations for Section 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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