

CHEAP STOCK VALUATION (409A, ASC 718 AND ASC 505-50)

Valuation of common stock in early stage companies has come a long way since the introduction of IRC 409A in 2005. Today we routinely issue joint valuation reports for tax and financial reporting; valuation and allocation approaches have developed into sophisticated computer models and the give and take between the valuation and audit communities continuously advances the discipline. In this Focus we address the most common questions from prospective clients regarding “409A/123R”<sup>1</sup> engagements.

**FAIR MARKET VALUE V. FAIR VALUE**

While there are firms that issue single purpose valuations, it is our position that clients are best served by using the same value for tax and financial reporting. The audit risk is too great if different assumptions are used for tax and financial reporting. Moreover, the IRS has indicated that it will review financial reporting assumptions as part of a 409A income tax audit.

While most financial reporting valuation work is performed under the ASC 805 definition of fair value<sup>2</sup>, the 2004 AICPA Practice Aide<sup>3</sup> makes an exception for work performed under FAS 123(R). Specifically, the Practice Aid states:

*“The AICPA has concluded that for purposes of determining the value of equity securities issued as compensation, the definition of fair value is consistent with the definition of fair market value under Revenue Ruling 59-60.”<sup>4</sup>*

In light of the above definition, it is difficult to understand how different values could be developed for these two purposes. Cogent Valuation issues dual purpose reports that satisfy the requirements under 409A as well as those imposed by the client’s auditor to validate option expense calculations.

**METHODOLOGY**

Cogent Valuation has been performing valuations of early stage venture backed companies for over 15 years. The methodologies used in today’s valuation work are adapted from basic valuation theory, such as the market and income approaches. By definition, early stage companies do not have actual financial performance on which to base a fundamental financial analysis or to use for capitalization. Instead we look to the future and use modified versions of traditional approaches to derive value indications.

The modified approaches include: the application of current market multiples to future expected performance; long-term discounted cash flow models which forecast cash flows of the subject company through commercialization; the use of venture based discount rates; the simulation of future funding events and the extended use of scenario analysis. Cogent Valuation strives to use several different and independent valuation approaches in each assignment in order to conclude the value of the equity.

**ALLOCATION**

The 2004 AICPA Practice Aid prescribes three distinct approaches to allocating equity value to a

company’s security classes. The Current Value Allocation (CVA) and the Option Pricing Method (OPM) are true allocation models while the Probability Weighted Expected Return Model (PWERM) is a complete valuation model. The CVA is currently used in limited circumstances which include extremely early stage companies that have not made significant progress on their business plans and as an allocation model in various exit scenarios of the PWERM.

The OPM has so far been used for the vast majority of valuations as its few assumptions facilitate the implementation and audit. One of the main criticisms of this model is its assumption of normally distributed outcomes. Many argue that the expected outcomes of an early stage company, especially in the life sciences industry, are not normally distributed but should rather be modeled with a much “thicker tail”.

**BACK-SOLVER**

THE OPM CAN ALSO BE USED AS A VALUATION MODEL THROUGH THE USE OF THE PRICING OF A RECENTLY ISSUED SECURITY AND A SOLVER ANALYSIS. THIS METHOD IS COMMONLY REFERRED TO AS A “BACK-SOLVER” AND THE APPROACH CAN BE USED FOR COMPANIES THAT HAVE HAD AN ARMS’ LENGTH TRANSACTION IN THEIR PREFERRED SECURITIES DURING THE MOST RECENT 60 TO 90 DAYS.

## EXPERIENCE AND EXPERTISE

In the past five years Cogent Valuation has performed over 300 “409A/123R” valuations for well over 100 companies. Our projects are well diversified and are sourced 50% from the technology sector, 40% from the life sciences & health care sector and 10% from the clean tech sector. We have particularly deep experience in non-traditional solar utility solutions, medical devices and text analytics. Our clients span the spectrum from seed stage ventures to established and profitable organizations. Approximately 50% of our projects are for B and C stage companies and more than 30% are for later stage companies. Nearly 70% of our first time clients return to Cogent Valuation for updates and additional work.

The utility and application of the PWERM is increasing as the industry debates the appropriateness of the underlying assumptions of the OPM. The PWERM is used in the valuation of late stage companies with somewhat clear ideas of their exit alternatives and for early stage life sciences companies. Further, it is the required model for pre-IPO companies. *Through our more than 300 409A/123R assignments, Cogent Valuation has developed the expertise to apply the appropriate allocation model for each situation.*

### DOCUMENTATION

Our clients receive a narrative valuation report at least annually. This report satisfies the IRS requirements regarding comprehensive valuation analysis being completed and thoroughly documented at least every 12 months. If there are interim updates, the comprehensive valuation analysis may be documented in an opinion letter which outlines new and revised assumptions and methodologies and is accompanied by a comprehensive set of exhibits. *Our view on valuation documentation is based on the formal requirements of 409A, our extensive experience with tax based valuation work and audit reviews over the last five years.*

### AUDIT REVIEW

While the threat of an IRS audit is a formidable reason for performing high quality and defensible valuations, the audit review is a more

immediate test of the completeness and quality of the work.

Approximately 60% of our work is reviewed by the client’s audit firm. The vast majority of these are with the Global Six accounting firms. The audit review should be a collegial process in which highly skilled and experienced valuation professionals exchange ideas and theories. It is from these discussions that models and theories are developed and improved. *Cogent Valuation encourages its clients to have the valuation reviewed concurrently by their audit firms’ valuation experts prior to finalization in order to avoid issues at the time of the audit. Many of our assignments incorporate a “kick-off” call with the audit team to identify and address material issues.*

### FREQUENCY

We recommend that our clients have valuations completed no less frequently than every 12 months. For clients that are nearing an IPO, we perform valuations more frequently (every one to three months) starting about one year prior to filing. *During the year we encourage our clients to stay in touch, to keep us updated on significant events, and maintain periodic dialogue so that we can decide jointly whether updates are necessary.*

Please contact Annika Reinemann or Steve Kam at 415-392-0888 for further information or to arrange a meeting.

### FOOTNOTES

- 1) In 2009 the FASB reclassified its accounting standards and 123(R) was replaced by ASC 718 and ASC 505-50. However, we continue to commonly refer to this type of valuation as 409A/123(R).
- 2) “Fair Value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date” FASB ASC 820, p.2
- 3) Valuation of Privately-held Company Equity Securities Issued as Compensation, AICPA Audits and Accounting Practice Aid Series, 2004
- 4) Valuation of Privately-held Company Equity Securities Issued as Compensation, AICPA Audits and Accounting Practice Aid Series, 2004, page 7, footnote 8.

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