cogent valuation

VALUATION FOCUS

PART TWO - REVISED PRACTICE AID : VALUATION OF PRIVATELY HELD COMPANY EQUITY SECURITIES ISSUED AS COMPENSATION

Part II of our focus[1] continues with the discussion of the exposure draft of the AICPA practice aid "Valuation of Privately Held Company Equity Securities Issued as Compensation"[2] regarding developments and changes to the original practice aid that was issued in April 2004. The topics discussed in this focus pertain to evolved thinking regarding the backsolve method, securities transactions as indicators of value, and quantitative methods used in the calculation of discount for lack of marketability.

THE BACKSOLVE METHOD IS FORMALLY ACCEPTED

In a prior Cogent Valuation focus entitled *Cheap Stock Valuation (409A, ASC 718 and ASC 505-50)*, we introduced the backsolve method as a popular valuation tool practitioners apply using an equity transaction to derive an implied value of the enterprise.[3] In the exposure draft, the Task Force formally acknowledges the validity and application of the backsolve method, while providing guidance as to the consideration of transactions in a company's equity securities and the implications these transactions can have on the valuation process.

In practice, the backsolve method has been used widely for the last few years, but its application and certain technical aspects of the methodology have continued to evolve such as consideration of events preceding or following a financing: "In applying the backsolve method, a valuation specialist should consider any events that were known or knowable as of the valuation date, including significant value-creating milestones, that could affect the value of the enterprise and have occurred since the latest financing round (or that are expected to occur prior to the next financing round, if the next financing round is pending)."[4]

Here, the Practice Aid explicitly states that practitioners and audit teams should not rely solely on a backsolve value indication as certain events occurring before and after the transaction could materially impact the enterprise value rendering the backsolve value stale or non-meaningful. Common material events include items that are company specific such as FDA regulatory approval, feedback from beta testing, loss of major customers, or industry specific issues such as those resulting from governmental regulatory changes or changes to competing technologies. A material event could also be an upcoming financing round, which should be considered against the backsolve value, placing particular emphasis on the likelihood and timing of the future financing round.

CONSIDERATION FOR ALL SECURITIES TRANSACTIONS

The Practice Aid also asserts the importance of actual securities transactions in the hierarchy of valuation methods. FASB's definition of fair value within ASC 718 and 505-50 requires us to consider all transactions, even those that are not of the traditional venture or private equity backed variety:

"Even if the most recent transactions were not arm's length, any recent or pending transactions in the company's equity securities would need to be considered when estimating the fair value of the other equity securities in the company, making adjustments as needed."

Importantly, all transactions, whether arm's length, strategic, insider or conducted in the secondary market, must be considered. That does not imply that all transactions must be relied upon as an indication of value. The specific facts and circumstances of each transaction, and the relative strengths and weaknesses of other valuation methods, will determine whether the transaction is a reliable indication of value. At the very least, atypical transactions such as direct equity investments from non-sophisticated investors, transactions in or redemption of founders' shares and secondary market transactions by speculators active in online exchanges such as SecondMarket and SharesPost should be analyzed and addressed in the valuation. The evolving viewpoints on these atypical transactions may be determinative in consideration of the FASB 718 and 505-50 definition of fair value, which is silent regarding "market participant", "informed buyer or seller", or "arm's length transaction."[5]

One example of an issue that may arise is the reliability of strategic transactions as a measure of fair value and fair market value for the company. The value of the strategic relationship could be measured and the transaction price adjusted to reflct value absent this element; or if the likely acquirer is a strategic buyer, it may be appropriate to leave the

Experience and Expertise

In the past five years, Cogent Valuation has performed approximately 350 valuations for over 100 companies for tax and financial reporting purposes in compliance with IRC Section 409A and FASB ASC 718 and 505-50, respectively. Our projects are well diversified and are sourced 50% from the technology sector, 40% from life sciences & health care and 10% from clean tech. We have particularly deep experience in non-traditional solar utility solutions, medical devices and text analytics. The phase of our clients' development ranges from seed ventures to established and profitable organizations. Approximately 50% of our projects are for B and C stage companies and over 30% are for later stage companies. 70% of our first time clients re-engage Cogent Valuation for follow-on or additional valuation services.

synergistic element of value in, representative of the price that would be paid by the most likely (market) participants. Another example is whether transactions involving non-sophisticated or speculative investors should be dismissed because neither group has sufficient access or capability to conduct an adequate financial due diligence.

Discounts For Lack of Marketability (DLOM)

For the last few years, the Protective Put model as first described by David Chaffe in 1993 has been the preferred quantitative DLOM model for its simplicity in use. A limitation of the Protective Put is that the model assumes an investor has the right to sell his stock position at today's market price at any time over the term of the holding period. In reality, the investor can sell his position at the prevailing market price at the time of sale, not at today's market price. In consideration of that limitation, the Practice-Aid describes two alternative methods: (1) the Finnerty model and the Asian protective put. Both models are average strike put option models which estimate the DLOM based on an average strike price during the assumed holding period rather than today's market price. We anticipate increased utilization of both the Finnerty model and the Asian protective put as these models hold conceptual advantages over the Protective Put model.

The Practice-Aid also introduces the Differential Put method, which can be used in a backsolve model to measure the incremental discount for common stock relative to the degree of illiquidity already incorporated in a backsolve valuation. This method potentially has extraordinary utility since the backsolve method applied to a recent financing round of preferred stock yields a common stock value that is neither fully marketable nor completely illiquid. The Differential Put in practice considers the difference between a company's asset volatility and equity volatility in the determination of incremental discount for common stock. Though the Differential Put was not discussed in substantial detail in the Practice-Aid, we expect further development on the method as practitioners and auditors grapple with the magnitude of illiquidity incorporated in preferred stock financings.

Cogent Commentary

The Practice Aid has confirmed the use of the backsolve method as an indicator of value but simultaneously introduced uncertainty regarding the reliance on securities transactions that may not at first glance appear to be meaningful indicators of value. Also, the Practice Aid introduced alternative DLOM models that address a limitation of the protective put option. Further development is required regarding the Differential Put method before it is widely applied in practice. Given the nuances and complexities of the topics presented above, and the dynamic nature in which current thinking is evolving, it is imperative that management retain a valuation firm that is at the forefront of developing and integrating techniques for ASC 718 and 505-50 valuations.

Please contact Steven Kam or Annika Reinemann at 415-392-0888 for further information.

Footnotes

1) *http://www.cogentvaluation.com/pdf/NewPracticeAid.pdf.*
2) *Working Draft – Valuation of Privately Held Company Equity Securities Issued as Compensation, AICPA Audits and Accounting Practice Aid Series, 2011.*
3) *http://www.cogentvaluation.com/pdf/CheapStockValuationAllocationMethods.pdf*
4) *Valuation of Privately-held Company Equity Securities Issued as Compensation, AICPA Audits and Accounting Practice Aid Series, 2004, page 31.*
4) *Ibid.*
5) *John D. Finnerty, "The Impact if Transfer Restrictions on Stock Prices" (presentation to the American Society of Appraisers Advanced Business Valuation Conference, Boston, MA October 2009).*

COGENT VALUATION OFFICES

San Francisco
601 California St., Suite 800
San Francisco, CA 94108
415.392.0888 V
415.392.7070 F

Los Angeles
15260 Ventura Blvd., Suite 1740
Sherman Oaks, CA 91403
818.905.8330 V
818.905.8340 F

Orange County
650 Town Center Dr., Suite 550
Costa Mesa, CA 92626
714.668.0272 V
714.668.0137 F

© 2011 Cogent Valuation. All Rights Reserved.