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Acquirer Challenges Early IRC 409A Report

An acquirer's due diligence team rejected a skimpy IRC 409A report as "inadequate," delaying the deal until the report could be redone properly

A venture backed company received an attractive acquisition offer from a well known Silicon Valley acquirer. But partway through the due diligence review the acquirer rejected an early "409A report" prepared by a one man valuation firm. Professionals from Teknos were hired to prepare a new report and the deal stayed on track.

CHALLENGE

A company formed by two serial entrepreneurs quickly attracted funds from several of the area's leading venture firms. At the time, the IRS had recently announced its planned regulations under IRC 409A, so the company obtained a low-cost valuation by a semi-retired CFO who had begun offering valuation services. A year later, at the urging of its Big Four audit firm, the company changed its valuation provider and used professionals from Teknos for the next independent valuation report.

Not long after that, the company made a sales presentation to a prominent Silicon Valley company and that discussion developed into a conversation about acquisition. A short time later the two companies signed a letter of intent. The terms of the deal were very attractive, providing both the founders and the venture investors with handsome returns.

The deal was proceeding smoothly toward a closing when the acquiring company's law firm called the selling company's law firm to discuss some issues uncovered during the due diligence review. Most of these were routine: poor documentation, missing employee agreements, and so on. But one issue was new: the acquirer had accepted the second IRC 409A valuation report, but it had rejected the first IRC 409A valuation report as "inadequate."

SOLUTION

The lead venture investor called to ask if Teknos could redo the rejected first IRC 409A valuation report, prepared by the semi-retired CFO, in the format used for the accepted second report, prepared by us. And could we do it quickly to keep the deal on track?

Analysis of Situation

It was discovered that the first IRC 409A report had been rejected by a Big Four audit firm team assisting the acquiring company with the due diligence review. They believed that the valuation report did not meet the standards established in the AICPA Practice Aid, *Valuation of Privately-Held-Company-Equity-Securities Issued as Compensation*, and Statement of Financial Accounting Standards No. 123, *Share-Based Payment*, revised (FAS 123R, now ASC 718). They also objected to the report because it did not take into account the value indicated by the Series A investment in the startup company.

Process and Outcome

Our valuation team reviewed the rejected valuation report and other material available from that time. We determined that we had enough information to redo the report and could do the work over the weekend.

Unfortunately, in the course of that work, we also determined that the indicated value of the common stock would be higher than the value in the first IRC 409A report. As the Big Four due diligence team had observed, the first report had been prepared by someone untrained in valuation and he had failed to consider the value indicated by the Series A investment. He also used an unorthodox allocation technique and an unacceptably high discount for lack of marketability. We pressed ahead and reworked the report, delivering it on time. The report was accepted by the buyer's due diligence team and the acquisition closed on schedule.

Despite the "happy ending" of the completed acquisition, there was an unresolved issue of whether the managers and employees of the startup company would someday be subject to an IRS challenge and confiscatory taxation on their gains (a 20% federal surtax and a 20% California surtax, plus interest and penalties). This was because the strike price of their options had been established using the value from the first IRC 409A report – a value that now might be considered too low after the challenge by the acquirer and the revised report.

Teknos recommends having every valuation report – no matter how early the company – conform to the AICPA Practice Aid and ASC 718. The IRS may never look at a report, but an auditor is sure to do so someday.

Teknos Associates is a valuation firm which serves emerging growth companies and their venture capital backers. We are a team of experienced and credentialed valuation professionals with backgrounds in appraisal, accounting, investment banking, and venture capital.

We provide appraisals to facilitate compliance with a variety of tax and accounting requirements, including option issuance and portfolio valuation. We support merger and acquisition activities with independent fairness opinions. And we offer valuations of intangible assets and liabilities after an acquisition.

We have produced hundreds of valuation reports quickly and economically, without sacrificing quality. Our reports have stood up to scrutiny by Big Four audit firms, the IRS, and the SEC. Contact us at to see how we can help you.

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