+1 415 898 1098
info@sorbusadvisors.com

Updated AICPA Guidance for IRC 409A / ASC 718 Valuations

Valuation of privately issued securities is a major concern among growing companies. Meaningful value conclusions help measure performance, assess strategic alternatives, and facilitate dialog among various stakeholders. Transparency and compliance with financial and tax reporting standards also rely on a credible valuation. AICPA Practice Aid, *Valuation Of Privately Held Company Equity Securities Issued As Compensation*, (the "Practice Aid") provides the key authoritative guidance. First published in 2004, the Practice Aid established a conceptual framework but left many specific technical questions unanswered. An exposure draft of the updated Practice Aid has recently been released. A summary of important topics clarified and expanded upon in its new reincarnation is shown below.

The initial publication of the Practice Aid in 2004 was a significant step toward establishing a fundamentally sound conceptual framework for the valuation of privately issued securities, such as common stock. It was designed to assist with financial reporting (FAS 123R) and tax reporting (IRC 409A). The new guidance recommended allocating business enterprise value to various tranches of equity based on their economic attributes. Business value could be estimated using established valuation techniques, such as income, market, and cost approaches. The allocation could be done using Option Pricing Method ("OPM"), Probability Weighted Expected Return Method ("PWERM"), or Current Value Method ("CVM"). Outside of this analytical framework, the valuation community needed to fill in the gaps and develop best practices.

Business Enterprise Value

While the Practice Aid expressly states that its purpose is to guide valuations of privately issued securities, it contains considerable discussion on how to value an underlying business as the key step in most analyses. Business valuation requires significant judgment in selecting appropriate methodologies and assumptions. Smaller private companies are especially challenging, lacking consistent financials and appropriate market (i.e., public) comparables. It is recognized that business valuation will remain the key source of variability in common stock value outcomes.

Hybrid Method

Hybrid Method is a new player among allocation methodologies, combining OPM and PWERM. It is appropriate when a company is likely to go through a transformative event (i.e., IPO or liquidation) in the near future. Just like PWERM, Hybrid Method is a scenario analysis. In one scenario, the company will remain independent and private, where OPM is the best approach. Another scenario may represent an IPO, merger, or liquidation. The value of the common stock is such a scenario is predetermined. Hybrid Method combines two outcomes into a single probability weighted valuation. Just like PWERM, Hybrid Method is intuitive and flexible, recognizing major strategic alternatives. It is also more sensitive to a large number of speculative assumptions, which require careful and thorough consideration.

Back-solve Method

Back-solve Method is a form of market approach. The price of recent financing or significant transaction is used to infer the value of a common stock. The Practice Aid directly endorsed this method, while ending lingering debate around its appropriateness. While straightforward in its implementation, the back-solve method should be used with care. First, transactions or financings that were not priced at arm's length should be given less weight. Pay-to-play provisions or new financing obtained from existing investors may contribute to inaccurate pricing. Significant business changes since transaction close also weaken the back-solve approach. Finally, other valuation methodologies should not be ignored, especially when the company has reliable financial information required to implement traditional income and market approaches.

Discount for Lack of Marketability

Discount for Lack of Marketability ("DLOM") has always been a significant issue. While practitioners agree that a marketable business interest is more valuable than a non-marketable one, the debate of how to measure marketability is likely to continue in the foreseeable future. The Practice Aid recommends using highly formulaic option pricing–based approaches, such as Protective Put, Asian Put, or Finnerty Model. At the same time, the use of restricted stock studies is not encouraged. The use of option pricing–based techniques simplifies financial reporting and satisfies most auditors. However, little case law exists to know what tax courts may think about option pricing–based approaches in the context of IRC 409A compliance.

Value of Common vs. Preferred or Debt

The Practice Aid provides more detailed guidance on how preferred equity and debt affect the value of common stock. The main discussion points concern equity volatility, OPM modeling, and discounting for control and marketability.

First, volatility assumptions should reflect overall capital structure. Leverage makes equity more volatile. It may also decrease comparability among guideline public companies and a subject company. Additional calculations may be required to bring observed equity volatilities in line with the subject capital structure.

Using debt as a breakpoint in the OPM model is not recommended. The Practice Aid outlines the method of including debt as a breakpoint if necessary.

The Practice Aid provides detailed guidance on marketability and control discounts in the context of various equity tranches. For example, it supports the notion that preferred shares are more marketable than common, but it does not support significant lack of control discounts for common stock. The view is that the value of control is sufficiently reflected in the economic attributes of equity tranches and thus accounted for in most enterprise value allocations.

Introduction of Real Options

Real Options analysis is an attractive and conceptually accurate way to account for significant strategic alternatives facing a company. R&D costs can be viewed as an investment in an option, where management has a right, but not an obligation, to continue the project after achieving or failing the next technical or commercial milestone. Management does not have to commit to the full cost of development unless intermediate steps are successful. As a result, technical, commercial, and business risks are all reduced, leading to higher valuation. The Practice Aid views the method as "useful" in valuing early stage companies. In our experience, the method is best used for strategic planning purposes around a single project in certain industries.

Dual Purpose Valuations

Many common stock valuation reports are written for dual, tax, and financial reporting purposes. While tax and financial reporting definitions or value are very similar, best practices around Fair Market Value rely on the case law. Fair Value opinions are typically scrutinized by audit firms and the SEC. It is important to understand that some of the best practices in tax valuations do not carry over to financial reporting valuations. For example, the discount for lack of control is routinely used in tax valuations. It is much harder to support in the financial reporting environment.

Conclusion

The Price Aid provides detailed guidance to valuing private securities in general and common stock in particular. It resolves a large number of technical issues developed since its initial publication in 2004. Much needed clarity is provided in the areas of allocation methodologies, control and marketability discounts, and complex valuation techniques. Importantly, the Practice Aid addressed relationships between separate and distinct tax and financial reporting regulatory environments. We believe it will continue to be the principal valuation guidance, and its conceptual framework will be expanded in many areas of tax and financial accounting. The next set of challenges will include second market transactions, greater integration of tax case law, and industry-specific best practices.

***Max Fonarev, MS, CFA** is a Principal at Sorbus Advisors LLC, an independent valuation advisory firm supporting financial reporting, tax reporting, and transaction planning. We strive to provide meaningful valuation opinions to improve compliance and empower strategic decision making. Mr. Fonarev is on LinkedIn, at +1.650.440.6035 or max@sorbusadvisors.com.*