

FINANCIAL REPORTING UPDATE

Equity Compensation

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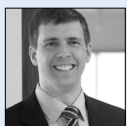
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Valuation Methods for Private Company Equity-Based Compensation

Equity-based compensation has been a key part of compensation plans for years. When the equity compensation involves a publicly traded company, the current value of the stock is known and so the valuation of share-based payments is relatively straightforward. However, for private companies, the valuation of the enterprise and associated share-based compensation can be quite complex.

The AICPA Accounting & Valuation Guide, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*, describes four criteria that should be considered when selecting a method for valuing equity securities:

- **Going Concern.** The method should align with the going-concern status of the company, including expectations about future events and the timing of cash flows. For example, if acquisition of the company is imminent, then expectations regarding the future of the enterprise as a going concern are not particularly relevant.
- **Common Share Value.** The method should assign some value to the common shares, unless the company is in liquidation with no expected distributions to common shareholders.
- **Independent Replication.** It is important that the results of the method used by a valuation specialist can be independently replicated or approximated using the same underlying data and assumptions. When completing the valuation, proprietary practices and models should not be the primary method of determining value.
- **Complexity and Stage of Development.** The complexity of the method selected should be appropriate to the company's stage of development. In other words, a simpler valuation method (like an OPM) with fewer underlying assumptions may be more appropriate for an early-stage entity with few employees than a highly complex method (like a PWERM).

For private companies, the valuation of the enterprise and associated share-based compensation can be quite complex.

With these considerations in mind, let's take a closer look at the four most common methods used to value private company equity securities.

Current Value Method (CVM)

The **Current Value Method** estimates the total equity value of the company on a controlling basis (assuming an immediate sale) and subtracts the value of the preferred classes based on their liquidation preferences or conversion values. The residual is then allocated to common shareholders. Because the CVM is concerned only with the value of the company on the valuation date, assumptions about future exit events and their timing are not needed. The advantage of this method is that it is easy to implement and does not require a significant number of assumptions or complex modeling.

However, because the CVM is not forward looking and does not consider the option-like payoffs of the share classes, its use is generally limited to two circumstances. First, the CVM could be employed when a liquidity event is imminent (such as a dissolution or an acquisition). The second situation might be when an early-stage company has made no material progress on its business plan, has had no significant common equity value created above the liquidation preference of the preferred shares, and for which no reasonable basis exists to estimate the amount or timing of when such value might be created in the future.

Generally speaking, once a company has raised an arm's-length financing round (such as venture capital financing), the CVM is no longer an appropriate method.

Probability-Weighted Expected Return Method (PWERM)

The **Probability-Weighted Expected Return Method** is a multi-step process in which value is estimated based on the probability-weighted present value of various future outcomes. First, the valuation specialist works with management to determine the range of potential future outcomes for the company, such as IPO,

The PWERM is most appropriate to use when the period of time between the valuation date and a potential liquidity event is expected to be short.

sale, dissolution, or continued operation until a later exit date. Next, future equity value under each scenario is estimated and allocated to each share class. Each outcome and its related share values are then weighted based on the probability of the outcome occurring. The value for each share class is discounted back to the valuation date using an appropriate discount rate and divided by the number of shares outstanding in the respective class.

The primary benefit of the PWERM is its ability to directly consider the various terms of shareholder agreements, rights of each class, and the timing when those rights will be exercised. The method allows the valuation specialist to make specific assumptions about the range, timing, and outcomes from specific future events, such as higher or lower values for a strategic sale versus an IPO. The PWERM is most appropriate to use when the period of time between the valuation date and a potential liquidity event is expected to be short.

Of course, the PWERM also has limitations. PWERM models can be difficult to implement because they require detailed assumptions about future exit events and cash flows. Such assumptions may be difficult to

support objectively. Further, because it considers only a specific set of outcomes (rather than a full distribution of possible outcomes), the PWERM may not be appropriate for valuing option-like payoffs like profit interests or warrants. In certain cases, analysts may also need to consider interim cash flows or the impact of future rounds of financing.

Option Pricing Model (OPM)

The **Option Pricing Model** treats each class of shares as call options on the total equity value of the company, with exercise prices based on the liquidation preferences of the preferred stock. Under this method, common shares would have material value only to the extent that residual equity value remains after satisfaction of the preferred stock's liquidation preference at the time of a liquidity event. The OPM typically uses the Black-Scholes Option Pricing Model to price the various call options.

In contrast to the PWERM, the OPM begins with the current total equity value of the company and estimates the future distribution of outcomes using a lognormal distribution around that current value. This means that two of the critical inputs to the OPM are the current value of the firm and a volatility assumption. Current value of the firm might be estimated with a discounted cash flow method or market methods (for later-stage firms) or inferred from a recent financing transaction using the backsolve method (for early-stage firms). The volatility assumption is usually based upon the observed volatilities of comparable public companies, with potential adjustment for the subject entity's financial leverage.

The OPM is most appropriate for situations in which specific future liquidity events are difficult to forecast. It can accommodate various terms of stockholder agreements that affect the distributions to each class of equity upon a liquidity event, such as conversion ratios, cash allocations, and dividend policy. Further, the OPM considers these factors as of the future liquidity date, rather than as of the valuation date.

The primary limitations of the OPM are its assumption that future outcomes can be modeled using a lognormal distribution and its reliance on (and sensitivity to) key assumptions like assumed volatility. The OPM also does not explicitly allow for dilution caused by additional financings or the issuance of options or warrants. The OPM can only consider a single liquidity event. As such, the method does not readily accommodate the right or ability of preferred shareholders to early-exercise (which would limit the upside for common shareholders). The potential for early-exercise might be better captured with a lattice or simulation model. For an in-depth discussion on the OPM, see our whitepaper [A Layperson's Guide to the Option Pricing Model](#) at [mer.cr/2azLnB](#).

Hybrid Method

The **Hybrid Method** is a combination of the PWERM and the OPM. It uses probability-weighted scenarios, but with an OPM to allocate value in one or more of the scenarios.

The Hybrid Method might be employed when a company has visibility regarding a particular exit path (such as a strategic sale) but uncertainties remain if that scenario falls through. In this case, a PWERM might be used to estimate the value of the shares under the strategic sale scenario, along with a probability assumption that the sale goes through. For the scenario in which the transaction does not happen, an OPM would be used to estimate the value of the shares assuming a more uncertain liquidity event at some point in the future.

The primary advantage of the Hybrid Method is that it allows for consideration of discrete future liquidity scenarios while also capturing the option-like payoffs of the various share classes. However, this method typically requires a large number of assumptions and can be difficult to implement in practice.

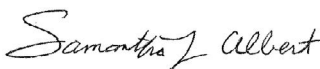
Conclusion

The methods for valuing private company equity-based compensation range from simplistic (like the CVM) to complex (like the Hybrid Method). In addition to the factors discussed above, the facts and circumstances of a particular company’s stage of development and capital structure can influence the complexity of the valuation method selected. In certain instances, a recent financing round or secondary sale of stock becomes a datapoint that needs to be reconciled to the current valuation analysis and may even prove to be indicative of the value for a particular security in the capital stack (see “[Calibrating or Reconciling Valuation Models to Transactions in a Company’s Equity](#)” on page 6). At Mercer Capital, we recommend a conversation early in the process between company management, the company’s auditors, and the valuation specialist to discuss these issues and select an appropriate methodology.



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	CVM	PWERM	OPM	Hybrid
Most Appropriate Use of the Model	Imminent liquidity event or extremely early-stage company	Known scenarios for future liquidity events with short period of time until the events	Situations in which specific future liquidity events are difficult to forecast	Partial visibility on future liquidity events, with uncertainty in the alternative
Advantages	Easy to implement and does not require forward-looking assumptions	Allows for discrete modeling of unique scenarios (range, timing, outcomes)	Recognizes option-like payoffs of share classes	Combines advantages of OPM and PWERM
Disadvantages	Not forward-looking Cannot account for option-like payoffs	Difficult to objectively support assumptions	Sensitive to key assumptions such as volatility Considers only a single liquidity event Cannot account for early exercise rights	Requires a significant number of assumptions May be complex and difficult to implement in practice

Simple vs. Complex Capital Structures

Executives expend a great deal of effort to determine the optimal way to finance the operations of their businesses. This may involve bringing on outside investors, employing bank debt, or financing through cash flow. Once the money has hit the bank, they may wonder, what effect does the capitalization of my company have on the value of its equity?

A company with a simple capital structure typically has been financed through the issuance of one class of stock (usually common stock). Companies with complex capital structures, on the other hand, may include other instruments: multiple classes of stock, forms of convertible debt, options, and warrants. This is frequent in startup or venture-backed companies that receive financing through multiple channels or fundraising rounds and private equity sources.

With various types of stock on the cap table, it is important to note that all stock classes are not the same. Each class holds certain rights, preferences, and priorities of return that can confer a portion of enterprise value to the shares besides their pro rata allocation. These often come in two categories: economic rights and control rights. Economic rights bestow financial benefits while control rights grant benefits related to operations and decision making.

Economic rights:

- Liquidation preference
- Dividends
- Mandatory redemption rights
- Conversion rights
- Participation rights
- Anti-dilution rights
- Registration rights

Control rights:

- Voting rights
- Protective provisions
- Veto rights
- Board composition rights
- Drag-along rights
- Right to participate in future rounds (pro-rata rights)
- First refusal rights
- Tag-along rights
- Management rights
- Information rights

The value of a certain class of stock is affected both by the rights and preferences it holds as well as those held by the other share classes on the cap table. The presence of multiple preferred classes also brings up the issue of seniority as certain class privileges may be overruled by those of a more senior share class.

Complex capital structures require complex valuation models that can integrate and prioritize the special treatments of individual share classes in multi-class cap tables. As such, models such as the PWERM or OPM are better-suited for these types of circumstances.



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Calibrating or Reconciling Valuation Models to Transactions in a Company's Equity

When an exit event is not imminent, the appropriate models to measure the fair value of a company with a complex capital stack are the Probability Weighted Expected Return Method (PWERM), the Option Pricing Method (OPM), or some combination of the two. While the choice of the model(s) is often dictated by facts and circumstances – for example, the company's stage of development, visibility into exit avenues, etc. – using either the PWERM or the OPM requires a number of key assumptions that may be difficult to source or support for pre-public, often pre-profitable, companies. In this context, primary or secondary transactions involving the company's equity instruments, which may or may not be identical to common shares, can be useful in measuring fair value or evaluating overall reasonableness of valuation conclusions.

For companies granting equity-based compensation, transactions are likely to take the form of either issuances of preferred shares as part of fundraising rounds or secondary transactions of equity instruments (preferred or

Illustrative List of Assumptions Required for OPM and PWERM

Assumptions	OPM	PWERM
Holding period	x	x
Discount rate(s)	x	x
Prospective financial information	x	x
Current pricing (multiples)	x	
Volatility estimate	x	
Avenues to exit		x
Likely pricing (multiples) at each exit avenue		x
Likelihood of each exit avenue		x
Expected dilution		x

common shares, as part of a fundraising round or on a standalone basis). Fundraising rounds usually do not provide pricing indications for common shares (or options on common) directly. However, a backsolve exercise that calibrates the PWERM and/or the OPM to the price of the new-issue preferred shares can provide value indications for the entire enterprise and common shares. While standalone secondary transactions may involve common shares, facts and circumstances around those transactions may determine the usefulness of related pricing information for any calibration or reconciliation exercise. Calibration, when viable, provides not only comfort around the overall soundness of valuation models and assumptions, but also a platform on which future value measurements can be based.

This article presents a brief discussion on evaluating observed or prospective transactions. Not all transactions are created equal – a fair value analysis should consider the facts and circumstances around the transactions to assess whether (and the degree to which) they are useful and relevant, or not.¹

Fair Value

ASC 718 *Compensation-Stock Compensation* defines fair value as “the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.” ASC 820 *Fair Value Measurement* defines fair value as “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.” While some of the finer nuances may differ slightly, both definitions make reference to the concepts of i) willing and informed buyers and sellers, and ii) orderly transactions.

Notably, ASC 820 includes the directive that “valuation techniques used to measure fair value shall maximize the use of relevant observable inputs...and minimize the use of unobservable inputs.” We take this to mean that pricing information from transactions should be used in the measurement (valuation) process as long as they are relevant from a fair value perspective.

Willing and Informed Parties

A fundraising round involving new investors, assuming the company is not in financial distress, tends to involve negotiations between sophisticated buyers (investors) and informed sellers (issuing companies). As such, these transactions are relevant in measuring the fair value of equity instruments, including those granted as compensation.

Pricing information from transactions should be used in the measurement (valuation) process as long as they are relevant from a fair value perspective.

¹ The discussion presented in this article is a summary of our reading of the relevant sections in the following:

- *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*, AICPA Accounting & Valuation Guide, 2013
- *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies*, Working Draft of AICPA Accounting & Valuation Guide, 2018

When a fundraising round does not involve new investors, the parties to the transaction are not necessarily independent of each other. However, such a round may still be relevant from a fair value perspective if pricing resulted from robust negotiations or was otherwise reflective of market pricing.

Secondary Transactions – Orderly Transactions?

As they give rise to observable inputs, secondary transactions can be relevant in the measurement process if the pricing information is reflective of fair value. Pricing from transactions in an active market for an identical equity instrument would generally reflect fair value. In other cases, orderly transactions – those that have received adequate exposure to the appropriate market, allowed sufficient marketing activities, and were not forced or distressed – can give rise to transaction prices that are reconcilable with fair value. Orderly secondary transactions that are relatively larger and those that involve equity instruments similar to the subject interests are more relevant.

Strategic Elements

Some fundraising rounds involve strategic investors who may receive economic benefits beyond just the ownership interest in the company. The strategic benefits could be codified in explicit contracts like a licensing arrangement. Consideration paid for equity interests acquired in such transactions may exceed the price a market participant (with no strategic interests) would consider reasonable. However, even as the pricing indication from such a transaction may not be directly relevant, it can be a useful reference or benchmark in measuring fair value. For example, it may be possible to estimate the excess economic benefits accruing to the strategic investors. Any fair value indication obtained separately could then be compared and reconciled to the price from the strategic fundraising rounds.

In other instances, strategic rounds may result in the company and investors sharing equally in the excess economic benefits. The transaction price could then be reflective of fair value, and a backsolve analysis to calibrate to the transaction price would be viable.

More Complex Structures

A tranching preferred investment may segment the purchase of equity interests into multiple installments. Pricing for such a round is usually set before the transaction and is identical across the installments, but future cash infusions may be contingent on specified milestones. Value of a company usually increases upon achieving technical, regulatory, or financial milestones. Even when future installments are not contingent on specified milestones, value may increase over time as the company makes progress on its business plan. Pricing set before the first installment tends to reflect a premium to the value of the company at the initial transaction date as it likely includes some expectation of potential economic upside from future installments. On the other hand, the same price may reflect a discount from the value of the company at future installment dates as the investments are (only) made once the economic upside is realized. Accordingly, a reconciliation to pricing information from these fundraising rounds may require separate estimates of the expectation of future upside (for the initial transaction date) and future values implied by the initial terms of the transaction (for later installment dates).

Some fundraising rounds involve purchases of a mix of equity instruments across the capital stack (i.e. different vintages of preferred and/or common) for the same or similar stated price per share. Usually, common shares involved in mixed purchases represent secondary transactions. From a fair value perspective, the transaction could be relevant in the aggregate and provide a basis to discern prices for each class of equity involved (considering the differences in rights and preferences among the classes). In other instances, either the company or the investor may have entered into a transaction for additional strategic benefits beyond just the economics reflected in the share prices. Depending on whether the buyer or the seller expects the additional strategic benefits, reported pricing may exceed the fair value of common shares or understate the value of the preferred shares. In yet other instances, mixed purchases at the same or similar prices may indicate a high likelihood of an initial public offering (IPO) in the near future. Typically, preferred shares convert into common at IPO and only one class of share exists subsequently.

Timing of Transactions and Other Events

Perhaps obviously, for both secondary and primary transactions, more proximate pricing indications are generally more directly useful for fair value measurement. Older, orderly transactions involving willing and informed parties would have been reflective of fair value at the time they occurred. If a more recent pricing observation is not available, current value indications could still be reconciled with the older transactions by considering changes at the company (and general market conditions) since the transaction date.

Planned future fundraising rounds could also provide useful information. In addition to the factors already addressed, a fair value analysis at the measurement date would need to consider the risk around the closing of the transaction.

Besides the usual transactions, other events that occur subsequent to the measurement date could still have a bearing on fair value. Future events that were known or knowable to market participants at the valuation date should be considered in measuring fair value. Events that were not known or knowable, but were still quite significant, may require separate disclosures.

For both secondary and primary transactions, more proximate pricing indications are generally more directly useful for fair value measurement.

Special Case – IPOs

An example of a special event on the horizon is an impending IPO. An IPO is usually a complex process that is executed over a relatively long period. At various points during the process, the company's board or management, or the underwriter (investment banker) may project or estimate the IPO price. These estimates may change frequently or significantly until the actual IPO price is finalized. Even the actual IPO price may be subject to specific supply and demand conditions in the market at or near the date of final pricing. Subsequent trading often occurs at prices that vary (sometimes drastically) from the IPO price. For these reasons, estimates or actual IPO prices are unlikely to be reflective of fair value for pre-IPO companies.

Setting aside the uncertainties and idiosyncrasies around the process, an IPO provides ready liquidity for investors and access to public capital markets for the company. The act of going public ameliorates the risks associated with the lack of marketability of investments in a company. Easier access to public markets generally lowers the cost of capital, which would engender higher enterprise values. Accordingly, fair value of a minority equity interest prior to an IPO is generally perceived to be meaningfully different from (estimates of) the IPO price.

Conclusion

Incorporating information from observed or prospective transactions can help calibrate the PWERM or the OPM (or other valuation methods), along with the underlying assumptions. However, a valuation analysis should evaluate the transactions to assess whether they are relevant. Even when they are not directly relevant, transactions can help gauge the reasonableness of valuation conclusions.

Valuation specialists are fond of thinking their craft involves a blend of technique and judgment. The specific mechanics of models and methods, and related computations, represent the technical aspect. There is certainly some judgment involved in developing or selecting the assumptions that feed into the models. Judgment plays a bigger role, perhaps, in weaving together the models, assumptions, valuation conclusions, and other facts and circumstances, including transactions, into a coherent and compelling narrative.

Contact Mercer Capital with your valuation needs. We combine technical knowledge and judgment developed over decades of practice to serve our clients.



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Shelf Life of an Equity Compensation Valuation

Clients frequently want to know, “How long is an equity compensation valuation good for?” We get it. You want to provide employees, contractors, and other service providers who are compensated through company stock with current information about their interests, but the time and cost required to get a valuation must also be considered.

Due to the natural business changes every company goes through, accounting and legal professionals often recommend updates at least annually if no significant change or financing has occurred. However, unique company or market characteristics often necessitate more frequent updates. Here are some of the factors to consider when determining the need for a valuation update:

- Significant changes in the company's financial situation
- Shift in overall strategy
- Achievement of business milestones
- Changes in market or industry conditions
- Gain or loss of major customer accounts
- Additional funding
- Issuance of new equity compensation
- Potential for an upcoming IPO
- Changes in expectation as to the timing of an exit event

Even for companies that have fairly steady operations, the effects of small business changes accumulate over time. Companies that deal with major changes relatively infrequently may be suited to regular summary updates to supplement full comprehensive reports as a way to maximize the cost-benefit analysis of equity compensation valuation.



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8 Things to Know About Section 409A

1. What is Section 409A?

Section 409A is a provision of the Internal Revenue Code that applies to all companies offering nonqualified deferred compensation plans to employees. Generally speaking, a deferred compensation plan is an arrangement whereby an employee (“service provider” in 409A parlance) receives compensation in a later tax year than that in which the compensation was earned. “Nonqualified” plans exclude 401(k) and other “qualified” plans.

What is interesting from a valuation perspective is that stock options and stock appreciation rights (SARs), two common forms of incentive compensation for private companies, are potentially within the scope of Section 409A. The IRS is concerned that stock options and SARs issued “in the money” are really just a form of deferred compensation, representing a shifting of current compensation to a future taxable year. So, in order to avoid being subject to 409A, employers (“service recipients”) need to demonstrate that all stock options and SARs are issued “at the money” (i.e., with the strike price equal to the fair market value of the underlying shares at the grant date). Stock options and SARs issued “out of the money” do not raise any particular problems with regard to Section 409A.

2. What are the consequences of Section 409A?

Stock options and SARs that fall under Section 409A create problems for both service recipients and service providers. Service recipients are responsible for normal withholding and reporting obligations with respect to amounts includible in the service provider’s gross income under Section 409A. Amounts includible in the service provider’s gross income are also subject to interest on prior underpayments and an additional income tax equal to 20% of the compensation required to be included in gross income. For the holder of a stock option, this can be particularly onerous as, absent exercise of the option and sale of the underlying stock, there has been no cash received with which to pay the taxes and interest.

These consequences make it critical that stock options and SARs qualify for the exemption under 409A available when the fair market value of the underlying stock does not exceed the strike price of the stock option or SAR at the grant date.

3. What constitutes “reasonable application of a reasonable valuation method”?

For public companies, it is easy to determine the fair market value of the underlying stock on the grant date. For private companies, fair market value cannot be simply looked up on *Bloomberg*. Accordingly,

for such companies, the IRS regulations provide that “fair market value may be determined through the reasonable application of a reasonable valuation method.” In an attempt to clarify this clarification, the regulations proceed to state that if a method is applied reasonably and consistently, such valuations will be presumed to represent fair market value, unless shown to be grossly unreasonable. Consistency in application is assessed by reference to the valuation methods used to determine fair market value for other forms of equity-based compensation. An independent appraisal will be presumed reasonable if “the appraisal satisfies the requirements of the Code with respect to the valuation of stock held in an employee stock ownership plan.”

A reasonable valuation method is to consider the following factors:

- The value of tangible and intangible assets
- The present value of future cash flows
- The market value of comparable businesses (both public and private)
- Other relevant factors such as control premiums or discounts for lack of marketability
- Whether the valuation method is used consistently for other corporate purposes

In other words, a reasonable valuation considers the cost, income, and market approaches, and considers the specific control and liquidity characteristics of the subject interest. For start-up companies, the valuation would also consider the company’s most recent financing round and the rights and preferences of any securities issued. The IRS is also concerned that the valuation of common stock for purposes of Section 409A be consistent with valuations performed for other purposes.

4. How is fair market value defined?

Fair market value is not specifically defined in Section 409A of the Code or the associated regulations. Accordingly, we look to IRS Revenue Ruling 59-60, which defines fair market value as “the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.”

5. Does fair market value incorporate a discount for lack of marketability?

Among the general valuation factors to be considered under a reasonable valuation method are “control premiums or discounts for lack of marketability.” In other words, if the underlying stock is illiquid, the stock should presumably be valued on a non-marketable minority interest basis.

This is not without potential confusion, however. In an Employee Stock Ownership Plan (ESOP), stock issued to participants is generally covered by a put right with respect to either the Company or the ESOP. Accordingly, valuation specialists often apply marketability discounts on the order of 0% to 10% to ESOP shares. Shares issued pursuant to a stock option plan may not have similar put rights attached, and therefore may warrant a larger marketability discount. In such cases, a company that has an annual ESOP appraisal may not have an appropriate indication of fair market value for purposes of Section 409A.

6. Are formula prices reliable measures of fair market value?

In addition to independent appraisals, formula prices may, under certain circumstances, be presumed to represent fair market value. Specifically, the formula cannot be unique to the subject stock option or SAR, but must be used for all transactions in which the issuing company buys or sells stock.

7. What are the rules for start-ups?

For purposes of Section 409A compliance, start-ups are defined as companies that have been in business for less than ten years, do not have publicly traded equity securities, and for which no change of control event or public offering is reasonably anticipated to occur in the next twelve months. For start-up companies, a valuation will be presumed reasonable if “made reasonably and in good faith and evidenced by a written report that takes into account the relevant factors prescribed for valuations generally under these regulations.” Further, such a valuation must be performed by someone with “significant knowledge and experience or training in performing similar valuations.”

This presumption, while presented as a separate alternative, strikes us as substantively and practically similar to the independent appraisal presumption described previously. Some commentators have suggested that the valuation of a start-up company may be performed by an employee or board member of the issuing company. We suspect that it is the rare employee or board member that is actually qualified to render the described valuation.

The bottom line is that Section 409A applies to both start-ups and mature companies.

8. Who is qualified to determine fair market value?

The safe harbor presumptions of Section 409A apply only when the valuation is based upon an independent appraisal, and it is likely that a valuation prepared by an employee or board member would raise questions of independence and objectivity.

The regulations also clarify that the experience of the individual performing the valuation generally means at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the service recipient operates.

In our reading of the rules, this means that the appraisal should be prepared by an individual or firm that has a thorough educational background in finance and valuation, has accrued significant professional experience preparing independent appraisals, and has received formal recognition of his or her expertise in the form of one or more professional credentials (ASA, ABV, CBA, or CFA). The valuation professionals at Mercer Capital have the depth of knowledge and breadth of experience necessary to help you navigate the potentially perilous path of Section 409A.



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