This bulletin offers an introduction to the Practice Aid titled Valuation of Privately-Held-Company Equity Securities Issued as Compensation, which was published by the American Institute of Certified Public Accountants (AICPA) earlier this year as part of its Audit and Accounting Practice Aid Series.

The Cheap-Stock Problem

The term “cheap stock” is often used to refer to the practice of granting stock or options to acquire stock at a price per share less than the fair value of that stock on the date of grant. Fair-value determinations made by private companies are subject to review by their auditors, the Internal Revenue Service, and, in connection with an initial public offering (IPO), the Securities and Exchange Commission (SEC). In connection with a company’s IPO, the SEC typically reviews a company’s option grant activity and fair-value determinations for the 12-18 month period preceding the filing of its registration statement. However, significant or unusual grant activity outside of this period may also attract SEC review and comment.

The AICPA Practice Aid

The Practice Aid was developed by a task force consisting of representatives from the big four accounting firms, leading valuation firms, the AICPA, corporations, academic institutions, and the National Venture Capital Association (NVCA). Wilson Sonsini Goodrich & Rosati was the only law firm represented on the task force. Representatives of the SEC and the Financial Accounting Standards Board (FASB) served as observers of the task force.

The Practice Aid outlines best practices, in the opinion of the task force, for valuing private-company securities issued as compensation. The Practice Aid is not an accounting standard and is not approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA, the FASB, or the SEC. However, the objective of the Practice Aid is to help reduce the risk of deficiencies in option pricing decisions by identifying and defining best practices for private companies to follow voluntarily. A complete copy of the Practice Aid is available for purchase at a price of $65.00 (AICPA members) or $81.25 (non-members) at www.aicpa.org/members/div/acctstd/vpes.asp.

The Concept of Fair Value

Fair value, as defined in Statement of Financial Accounting Standard (SFAS) 123, is the amount at which a minority common-stock interest in a privately held enterprise could be bought or sold in a current transaction between willing parties, other than in a forced or liquidation sale. The FASB has preliminarily indicated that fair value as defined in the accounting literature is consistent with fair market value as defined by the IRS.

For purposes of determining the fair value of private-company securities, the Practice Aid reviews various indicators of fair value and ranks them in the following order:

1. Published trading prices in active markets;
2. Recent arms-length cash transactions with independent third parties; and
3. Enterprise valuations based on market-, income- or asset-based methodologies.

While published trading prices in active trading markets provide the best evidence of fair value, they are not available for privately traded companies. Arms-length transactions with independent third parties for the sale of private-company securities do exist.

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Valuation of Private Company Securities

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However, such transactions are infrequent events that rarely coincide with the relevant measurements date and, even when they do take place on or around the measurement date, they often involve a different class of stock than the one being valued. Accordingly, the Practice Aid provides in-depth guidance on valuing private-company securities in the absence of published trading prices or arms-length transactions in the same class of stock. The Practice Aid also provides guidance on allocating value among different classes of stock issued by the enterprise.

Hierarchy of Enterprise Valuation Methods

A central theme of the Practice Aid is that the valuation of private-company securities requires sophisticated techniques, experience, and independence. The reliability of a valuation depends upon experience, timing, and objectivity. Accordingly, the Practice Aid sets out the following hierarchy of valuation alternatives to be used in determining who performs the valuation and how often a valuation is done:

1. A contemporaneous valuation by an independent valuation specialist;
2. A retrospective valuation by an independent valuation specialist; and
3. A contemporaneous or retrospective valuation by a related valuation specialist.

The Practice Aid strongly encourages the use of Level 1 valuations and suggests that the risk of challenge for a valuation should be lowest at Level 1, provided that the assumptions and techniques used in the valuation are reasonable. For Level 2 and 3 valuations, the Practice Aid recommends that the party relying on such valuation provide information regarding the factors, assumptions, and techniques used; the reasons why a Level 1 valuation was not obtained; and, in the case of retrospective valuations, a reconciliation of the valuation report findings and the value of the securities on the reference date, such as the date of significant option grant activity and/or the date of a company’s IPO. For companies in the IPO process, the Practice Aid recommends that this information be included in the company’s registration statement.

Frequency of Valuations

In order for a valuation to qualify as a Level 1 valuation, it must be contemporaneous with the relevant measurement date, such as the date of significant option grant activity. The meaning of contemporaneous in this context depends on the facts and circumstances of the company being valued. In general, a valuation will be considered contemporaneous if it is completed at or around the measurement date and no material changes to the company’s business or value drivers have occurred between the valuation date and the measurement date. Accordingly, the frequency of valuations required to remain at Level 1 will depend on the timing of material changes, milestones, or other developments involving the company. The Practice Aid recommends that companies obtain a series of third-party valuations, with the interval between such valuations being influenced by factors set forth in the Practice Aid, including:

- The timing of significant events or milestones that are expected to affect the company’s value;
- The issuance of equity securities, including financing transactions and significant option grants; and
- The company’s stage of development.

Companies seeking to obtain a series of valuations may wish to retain an independent valuation specialist to perform such valuations at pre-negotiated prices for the first valuation and each subsequent valuation. Whether a subsequent valuation is simply an update or an entirely new and complete valuation will depend on the nature of changes to the company’s business and value drivers between the two valuation dates.

Fair Value of the Enterprise

In the absence of quoted market prices or recent arms-length transactions in a company’s stock, the valuation of company securities generally begins with the valuation of the enterprise as a whole. Valuation specialists typically consider more than one method in determining enterprise value. These methods include:

- The income approach, which measures value based on the expected present value of the company’s projected future cash flows;
- The market approach, which measures value based on the value of similar companies that are publicly traded or have recently been acquired in public disclosed transactions; and
- The cost approach, which measures value by restating the assets and liabilities of the enterprise at their current fair market value.

The Practice Aid discusses the suitability of each of these methods at various stages of an enterprise’s development, with the cost approach applied more often during earlier stages when the information required to apply the income or market approaches may not be available.

Marketability Discounts

The Practice Aid discusses the application of marketability discounts when valuing private-company securities based in part on data regarding publicly traded companies. While the Practice Aid recognizes that a marketability discount may be appropriate, it recommends the valuation specialist take a number of factors into account in determining the size of the marketability discount. The Practice Aid suggests that the marketability discount be reduced for certain factors including:

- Lower perceived risk and volatility associated with the enterprise;

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• Contractual arrangements that increase liquidity, such as put rights and registration rights; the absence of contractual arrangements that limit liquidity, such as transfer restrictions, drag-along rights, and rights of first refusal; and
• Strong and recognizable indicators of enterprise value that lead to greater certainty about the enterprise's value and the value of its stock.

Allocation of Enterprise Value

Once a company's enterprise value has been determined, that value must be allocated among its various classes of equity securities. The Practice Aid recognizes that there are significant differences between common and preferred stock that affect their respective values. The Practice Aid also recognizes that some rights and preferences, such as liquidation preferences, are easier to measure and value than others, such as anti-dilution rights and voting rights. In addition, it specifically rejects the use of "rules of thumbs" in allocating value between preferred and common stock. An example of such a rule of thumb is the pricing of common stock at 10 percent of the preferred stock price.

An enterprise's value must be allocated among its classes of stock based on the differences in rights associated with such stock, taking into account the circumstances and prospects of the enterprise and the likelihood that such special rights and preferences will be triggered. The Practice Aid describes three enterprise value allocation methods and the pros and cons of each. These methods are:

• the current value method;
• the option pricing method; and
• the probability-weighted expected return method.

These methods are not the only allocation methods that may be used. The Practice Aid simply suggests that the method used should take into account the stage of the company's development and the applicability of the particular method.

The Current Value Method

The current value method assumes that the enterprise is immediately liquidated with the proceeds available for distribution being equal to the overall enterprise value. This method then allocates the enterprise value in accordance with the liquidation preference provisions of the preferred stock set forth in the company's charter documents. The fair value of each class of stock is then determined based on the return per share payable to such class in the assumed liquidation.

The key advantage of the current value method is its ease of implementation. This method also has a certain mathematical elegance and simplicity that has resonated with many private-company auditors. However, the principal limitation of this method is that the immediate liquidation of the company is not, in most cases, a realistic assumption. As a result, the Practice Aid limits the application of this method to situations in which a liquidation or acquisition transaction is imminent or the company is an early-stage enterprise where no material progress has been made on its business plan and there is no reasonable basis for estimating the timing and amount of any common equity return that might be realized in the future—which makes the application of the other methods described below difficult, if not impossible.

The Option Pricing Method

The option pricing method of allocating enterprise value among common and preferred stock views each class of stock as a call option on all or part of the enterprise's value. This method utilizes option pricing models such as Black-Scholes to price each call option.

The key advantage of this approach is that it considers the impact of liquidation preferences over a range of future liquidation values and dates. However, this method is complicated to implement and sensitive to key assumptions. In addition, since private companies are being valued, the lack of trading history makes the volatility assumption used in the valuation formula very subjective. Overall, the task force concluded that this approach is most applicable to mid- to later-stage companies that have a wide range of possible future outcomes ahead of them.

The Probability-Weighted Expected Return Method

The probability-weighted expected return method is the most theoretically pure approach to allocating enterprise value, but, it is also one of the most difficult methods to implement. Under this method, the value of the enterprise is determined at each point in a range of future outcomes and dates. Typical future outcomes for a company include liquidation, acquisition, IPO, and continued existence as a private company. In its simplest form, this method involves the following steps:

1. Determine the value of the enterprise at each future outcome and the most likely date of each outcome;
2. At each outcome, determine the allocation among common and preferred stock based on the liquidation preferences of each;
3. Discount the per share returns to present value using a risk-adjusted discount rate;
4. Assign probabilities to each outcome; and
5. Multiply the probability of each outcome by the expected return per share for that outcome to determine the probability-weighted expected return for each class of stock.

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The above outline uses a single future date and valuation for each of the outcomes. More complex forms of this approach use a range of enterprise values and a range of possible dates for each outcome. This is done using statistical models and volatility estimates similar to the Black-Scholes method. While such models exist and are in use on a proprietary basis, they tend to add complexity and lack transparency in their application.

The probability-weighted expected return method is conceptually strong and forward-looking. It considers the rights of each class at times when those rights are expected to be applied and is not as sensitive as the other two methods to a change in a single assumption. However, this method relies on a very large number of assumptions. This approach is also complicated to implement and the estimates of probabilities, dates, and values are difficult to support.

The Practice Aid indicates that there is no generic or textbook version of this model (such as the Black-Scholes approach to the option pricing method). Instead, it suggests that valuation specialists develop their own frameworks for applying this model.

Conclusion

As indicated above, the Practice Aid is not an accounting standard, and is not approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA, the FASB, or the SEC. The objective of the Practice Aid is to identify and define best practices for private companies to follow voluntarily, based on the task force’s belief that auditors and regulators may give greater weight to results obtained using such practices, properly applied. Since the release of the Practice Aid, accounting firms have begun to rely on it as a tool for reviewing option pricing decisions of their private-company clients in connection with year-end audits. In addition, recent experience in a limited number of IPO filings does suggest that members of the SEC staff are taking the recommendations of the Practice Aid into account in their review of registration statements. However, more time is needed to determine whether the Practice Aid will fulfill its objectives of providing a framework for valuing private-company securities and bringing greater predictability and certainty to option pricing decisions.