Valuation Aspects of IRC 409A and FAS 123R

Supplemental Handout for: CFO Roundtable

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EXTEND YOUR REACH

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What is IRC 409A?

- Created by American Jobs Creation Act of 2004, enacted Oct. 22, 2004
- Materially changes tax treatment of nonqualified deferred compensation plans and arrangements

(New rules for timing of elections to defer compensation under a <u>nonqualified deferred compensation</u> (NQDC) plan, New rules for when distributions can be made under a NQDC plan; New rules relating to funding of NQDC)

- Covers multitude of situations:
  - Deferred compensation provisions in various types of agreements, including offer letters and employment, non-compete and consulting agreements
  - Bonus plans
  - 401(k) mirror plans
  - Supplemental executive retirement plans
  - Severance agreements (some exceptions for 2005 only)
  - **Phantom stock**
  - **Stock appreciation rights**
  - **Discounted stock options**

Definition of NQDC

A plan provides for the deferral of compensation if:

- The service provider has a legally binding right during a taxable year to compensation…

- That has not been actually or constructively received and included in income…

- And that is payable in a later year

- A right can be legally binding even if subject to a substantial risk of forfeiture

NQDC <u>is not</u>

NQDC **does not** include:

- A qualified employer plan
- A bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan
- ISOs and ESPP options (have FMV requirement, anyway)
- Restricted stock (EEs need to report if making 83B election) & Restricted stock *units (*A Restricted Stock Unit is a grant valued in terms of company stock, but company stock is not issued at the time of the grant.)
- Nonstatutory stock options (NSOs) in service recipient stock if granted at FMV (safe harbor provided)
- Stock appreciation rights (SARs) in service recipient stock if granted at FMV (safe harbor provided)

NQDC <u>does</u> include

NQDC **does** include:

- Top-Hat plans, SERPs (Supplemental Executive Retirement Plan), Excess plans
- Phantom stock plans
- Discounted nonstatutory options and stock appreciation rights (SARs)
- Programs that allow deferral of option income
- Certain severance arrangements

IRC 409A Written Plan Requirement

- Written plan is required for any arrangement other than short-term deferral (and are advisable for short term deferral plans)
- “Plan” can consist of more than one document
- A plan is established on the later of the date adopted, effective, or date material terms are set forth in writing

IRC 409A - Current Deadlines

- **December 31, 2007 deadlines**

  (Final regulations issued April 10, 2007 and are effective January 1, 2008)

  – Amendments to deferred compensation plan to either:
    - Bring plan into compliance with Sec. 409A, or
    - Change plan to eliminate any deferral of compensation, so that plan not subject to Sec. 409A

  – Employees' elections re: time and form of payments

- **Good faith compliance required now**
  - Until December 31, 2007, existing standard applies
  - Compliance with proposed regulations treated as good faith compliance

IRC 409A - Penalties for Non-Compliance

- For **recipients** of nonconforming awards, all deferred amounts for all taxable years become immediately taxable at underpayment rate *plus* 1% (For stock right-related compensation, tax liability is incurred upon *vesting)* ; and
- **Participants** required to pay *additional* 20% penalty
- **Issuing company** may face potential exposure for failing to withhold or report on award amounts deemed to be income

Stock Rights under the Regulations

- The term "stock rights" includes SARs and nonstatutory stock options

- As under the Notice, both stock options and SARs must be in "service recipient" stock in order to be exempt from Section 409A:

– Must be granted at no less than FMV

– Cannot have any additional deferral feature

“Service Recipient Stock”

- **Service Recipient Stock.** In order to be exempt from Section 409A, a stock option or SAR must be issued with respect to "service recipient stock." The final regulations expand the definition of "service recipient stock" to include any class of common stock that does not have any preferential payment right and the stock of any corporation in a chain of organizations all of which have a controlling interest in another organization, beginning with the parent organization and ending with the organization for which the service provider was providing services at the date of grant.

Definition of Date of Grant

- Not addressed in previous guidance (final regs)
- Refers to the date when the necessary corporate action is taken to create a legally binding right

Need to include:

- Maximum number of shares and minimum exercise price that are fixed or determinable
- Class of underlying stock identified
- Identity of recipient designated

- Any unreasonable delay in notifying employees may be an indication that the grant date is not the date corporate action is complete.

Other Rules Relating to Stock Rights

- Extensions, Renewals, Modifications
- 409 A addresses; we will not cover here.

What is the Valuation Component?

- Securities, issued as deferred compensation, and subject to scrutiny include:
  - Stock Options
  - Phantom Stock
  - Stock Appreciation Rights
  - Restricted Stock (for EE tax consideration & FAS123R)

Valuation Component – IRC 409A requires…

- **Conforming awards** will have an **exercise price** of securities awarded as deferred compensation equal to or greater than **Fair Market Value** at time award granted

- Fair Market Value determined by "*a reasonable application of a reasonable valuation method*"

Standard of Value

- **Fair Market Value (IRS)**

  The price at which the property would change hands between a hypothetical willing buyer and a hypothetical 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.

- **Fair Value (GAAP,FASB)**

  For financial reporting purposes, the appropriate standard of value is fair value, which is similar to the fair market value definition according to FASB.

A “reasonable application”…

A “reasonable application” considers relevant valuation factors: (Revenue Ruling 59-60 criteria)

- Valuation of tangible and intangible assets
- Present value of future cash-flows
- Market value of stock or equity interests in similar entities engaged in substantially similar trades or businesses
- Trading prices for public companies
- Arm’s length private transactions
- Other relevant factors such as control premiums or discounts for lack of marketability
- Whether the valuation method is used for other purposes that have a material economic effect on the service recipient, its stockholders, or its creditors, and…

A "reasonable application"…

………and……,

- **Should be consistent with valuations performed for other purposes (such as financial reporting)**

Other Valuation Factors (not defined in 409A)

- Milestones achieved by the company
- State of the industry & economy
- Members of management & board of directors
- Marketplace & major competitors
- Barriers to entry
- Competitive forces
- Existence of proprietary technology, project, or service
- Workforce & workforce skills
- Customer & vendor characteristics
- Strategic relationships with major suppliers or customers
- Major investors in the company
- Cost structure & financial condition
- Attractiveness of industry segment
- Risk factors faced by the enterprise
- Qualitative & quantitative factors

Valuation Presumptions (Private Companies)

A "reasonable method" :

…a valuation is presumed reasonable if one of three valuation methods is applied. The following three methods are expected to be applied:

Appraisal Presumption

- ✓ appraisal performed by independent appraiser
- ✓ appraisal performed within 12 months of relevant grant date
- ✓ no material events transpired between appraisal and grant dates that would impact valuation
- ✓ companies within 90 days of a change in control or sale, or 180 days of IPO expected to rely on this presumption

Valuation Presumptions – (Private Companies), cont.

Buy-Back Presumption

- ✓ where the valuation is based on a buy-back formula that is applicable for both compensatory and noncompensatory purposes and would be treated as fair market value under Section 83 of the Internal Revenue Code (subject to certain rules);

(In other words, if a buy-sell formula applies to all transactions involving the company's stock, then the buy-sell formula can be used to value stock as of a given date)

What is the Valuation Component? Valuation Presumptions – (Private Companies), cont.

Illiquid Stock Presumption

- ✓ reasonable good faith valuation supported by written report
- ✓ appraisal takes into consideration certain standard valuation factors
- ✓ Relied upon by early stage, private companies that satisfy following conditions:
  - does not have class of equity securities traded on established securities market
  - has conducted business for < 10 years
  - subject stock not subject to put or call rights other than right of first refusal or unvested share repurchase right
  - the company is not reasonably expected to undergo a change in control within 90 days or conduct a public offering within 180 days of the date the valuation is used (under the proposed regulations, the company could not reasonably expect to undergo such events within 12 months of the date the valuation was used), and….

Valuation Presumptions – (Private Companies), cont.

Illiquid Stock Presumption, cont.

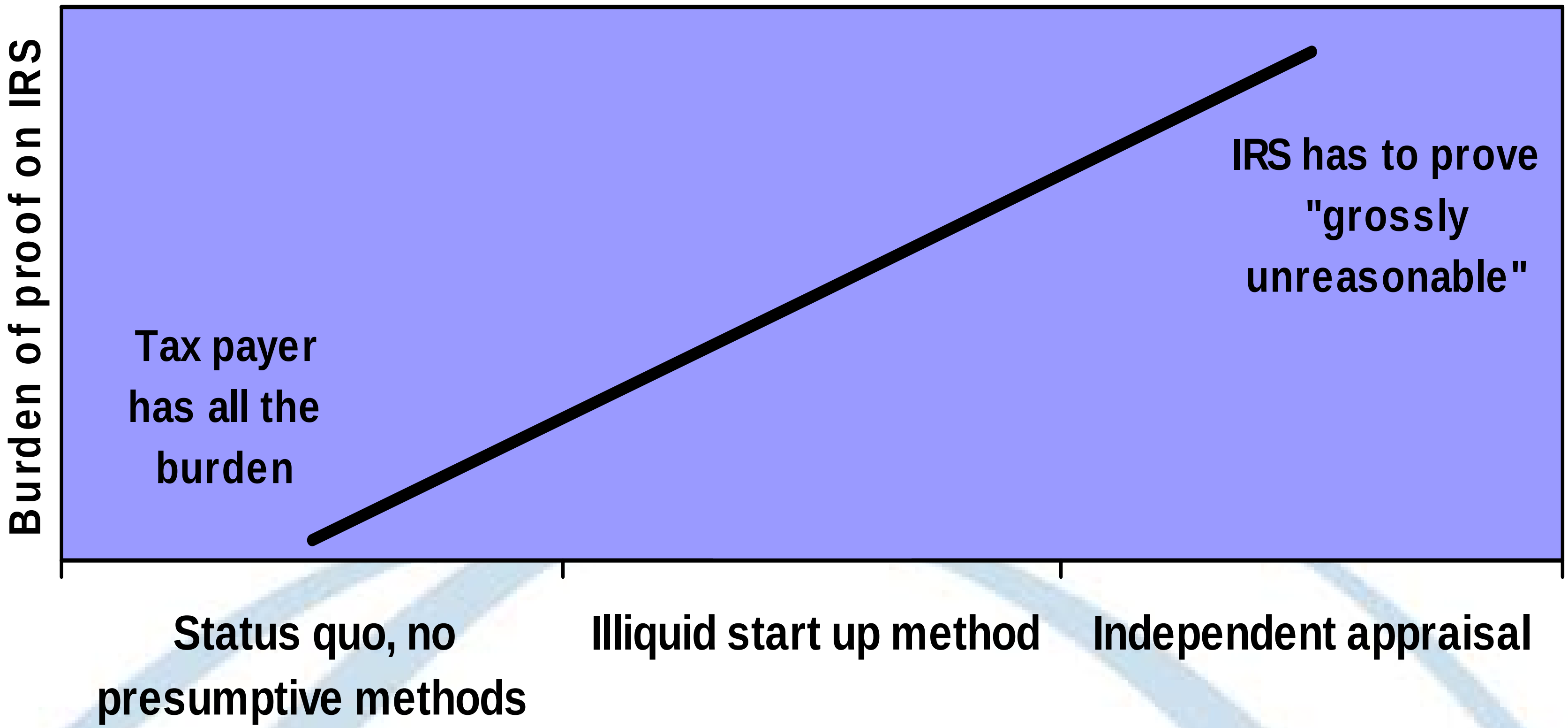
…and…

- the valuation is performed by a person or persons that the corporation reasonably determines is qualified to perform the valuation based on the person or persons' significant knowledge, experience, education, or training.
- The final regulations clarify that significant experience 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 corporation operates.

A Valuation is <u>not reasonable</u> if…

- It does not take into account all available information that is material to value,
- It fails to take into account information available after the date of the calculation that may materially affect the value of the corporation (for example,the resolution of material litigation or the issuance of a patent), or
- **The value was calculated as of a date that is more than 12 months earlier than the date on which the valuation is being used (shelf-life)**

Shifting the Burden to the IRS



Valuation Issues, Private Companies

- For private companies, independent appraisal *not* required, *but…*
- The appraisal exercise will need to be undertaken for each option grant date as the value of the stock will likely have changed with the passage of time
- In this regard, independent 3rd party appraisals will offer the most assurance of compliance
- Final Regs rejected requests for a good faith standard like the one applicable to ISOs
- Consistency of valuation method *not* required

Valuation Issues, Public Companies

The final regulations provide that a public company may base the fair market value of its stock on:

- the last sale before or the first sale after the grant;
- the closing price on the trading day before or the trading day of the grant;
- the arithmetic mean of the high and low prices on the trading day before or the trading day of the grant (this factor was not in the proposed regulations); or
- any other reasonable method using actual transactions in the stock as reported by the market.

Valuation Issues, Public Companies

- The proposed and final regulations provide that fair market value also may be determined using an average selling price during a specific period of time. Under the final regulations, the specific period of time in which the fair market value may be determined must be within 30 days before or 30 days after an applicable valuation date (instead of the date of grant, as was required by the proposed regulations).
- The final regulations require that the decision or commitment to base the fair market value on the average selling price method must be irrevocably made before the specific time period begins, and the company must designate at the same time the following items:
  - the recipient of the stock right;
  - the number and class of shares covered by the stock right; and
  - the method that will be used to determine the exercise price (including the length of time that will be used to determine the average selling price). Foreign country (i.e., France) requirements for determining exercise price will be respected as long as averaging period does not exceed 30 days

Inter-relationship with Financial Accounting

- Consistency between valuations performed for 409A and financial reporting for compensation is typically expected

- So, this is not just a tax issue – it is an accounting issue too

- AICPA Practice Aid – *Valuation of Privately-Held-Company Equity Securities Issued as Compensation, (issued in 2004)* has become authoritative guidance on how to address these valuations amongst valuators *:*

  – Describes three valuation methodologies that should be considered in the valuation of a pre-IPO company

  –Valuations methodologies required under the Practice Aid can be complicated

- Cheap stock issues for pre-IPO companies:
  – Significant scrutiny by the SEC of registration statement

What is SFAS 123R?

- Covers employee share-based payments & requires that Companies expense for all equity-based awards, including stock options and employee stock purchases, in their financial statements.
- Released on December 16, 2004, went into effect for public companies beginning in 2005
- For practical purposes the 123(R) requirements for private companies are effective January 1, 2006
- New valuation complexities (fair value)
- Supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*

Overview of the AICPA Practice Aid: *Valuation of Privately-Held Company Equity Securities Issued as Compensation*

- Upholds the concept of fair value in financial reporting:
  - ✓ May 7, 2003, FASB Board Meeting Minutes
- Addresses Stages of Enterprise Development
- Includes Hierarchy of Valuation Alternatives
- Includes Approaches to determining Enterprise/Equity Fair Value
- Includes Common rights associated with preferred stock
- Includes Documents to request in performing these engagements and limiting conditions to include in the valuation report
- Includes Approaches to valuing/allocating Enterprise/Equity Fair Value

Company Stages & Valuation Approaches

Stage	Operational Development	Typical Financing	Valuation Approach Typically Applicable
1	No product revenues to date and limited expense history, typically an incomplete management team with an idea, plan, and possibly some initial product development	Seed capital (common stock)	Asset-based
2	Still no product revenue but substantive expense history, as product development is underway and challenges are thought to be understood	1st & 2nd rounds (preferred stock)	Asset-based
3	Significant progress in product development; key development milestones met and development is near completion, but generally no product revenue	3rd & 4th rounds (preferred stock)	Market (maybe Income)

Company Stages & Valuation Approaches (cont.)

Stage	Operational Development	Typical Financing	Valuation Approach Typically Applicable
4	Additional key development milestones met and some product revenue, but still operating at a loss	Mezzanine rounds (preferred stock)	Market, Income
5	Product revenue and operating profitability or breakeven/positive cash flows	IPO or other liquidity event (common stock)	Market, Income
6	Established financial history of profitable operations or generation of positive cash flows	IPO or other liquidity event (common stock)	Market, Income

Enterprise/ Value Allocation Methods for Companies w/ Complex Capital Structures

The *Practice Aid* lists three enterprise/equity valuation and value allocation methods.

They are:

1. Current value method (CVM)

2. Option-pricing method (OPM)

3. Probability-weighted expected return method (PWERM)

General Comments Applicable to All Three Methods

- No single method is superior to the others in all circumstances
- Empirical support for critical inputs may be difficult to obtain
- The analyst should consider the specific facts and circumstances surrounding the enterprise in selecting the most appropriate method(s)
- In implementing the selected method(s), consider the terms of the related stockholder agreement or indentures
- None of the methods take into account all the features a preferred security may possess

Factors to Consider in Selecting a Method

- Does the method reflect the going concern expectations of each class of security holder?
- **Does the method ascribe some value to the common stock if the enterprise is not in liquidation (or its liabilities exceed its assets)?**
- Can the results be independently replicated or approximated?
- Do the benefits of using the model exceed the cost of implementation?

Current Value Method (CVM)

- Allocates current value of the enterprise to each class of security based on its present rights, preferences and conversion features (i.e., ignores preferred's ability to defer the conversion decision).
- Is appropriate in two limited circumstances:
  - ➢ A liquidity event is imminent that does not force the conversion of preferred into common.
  - ➢ The enterprise is at such an early stage of development that:
    - ✓ No material progress has been made on the business plan.
    - ✓ No significant common equity value has been created.
    - ✓ There is no reasonable basis for estimating the amount and timing of probable future common value.

Option Pricing Method (OPM)

- Treats common and preferred stock as call options on enterprise value.
- Utilizes Black-Scholes or binomial models to calculate value
- Is useful for valuing securities when there is a high degree of uncertainty regarding their potential future values.
- Is sensitive to estimates of volatility and term/life.
- Requires valuation of the enterprise at time zero.
- Does not capture the effects of potential future radical spikes in value as well as PWERM.

OPM – Steps in Application

The following steps are applied in the Option Pricing Model:

1. Establish the enterprise value
2. Analyze equity rights for each class to establish breakpoints
3. Select BSOPM or Binomial model
4. Develop valuation inputs such as volatility and term
5. Calculate the fair value of the subject security

Probability-Weighted Expected Return Method (PWERM)

- Rooted in decision-tree analysis.
- Models potential future expected outcomes (sale or merger; IPO; dissolution; or continuation as a going concern)
- Encompasses the following steps:
  - ✓ Estimate future values for each potential outcome
  - ✓ Allocate future value to each share class
  - ✓ Discount to present value, by class, these potential future values
  - ✓ Assign probabilities to each outcome
  - ✓ Estimate share value by summing the probability-weighted outcomes

PWERM – Steps in Application

The steps in applying the PWERM are as follows:

1. For each possible future event, future values of the Company are estimated at certain future points in time
2. For each event value and date, the rights and preferences of each shareholder class are considered in order to determine the appropriate allocation of value between the member classes.
3. For each possible event, an expected future value is calculated for each shareholder class. This future value is then discounted to a present value using an appropriate risk-adjusted discount rate.
4. A probability is estimated for each possible event based on the facts and circumstances as of the valuation date.
5. Based on the probabilities estimated for the possible events, a probability-weighted value, is then determined for each shareholder class.

Valuation of Preferred Stock Rights

- Two broad methods of valuing and/or quantifying the various preferred stock rights and preferences:
  - ✓**Bottom-up approach**: Uses the pricing of recent instruments to derive the value of another class of equity
  - ✓**Top-down approach**: Establishes enterprise fair value and then allocates among the various equity classes
- It should be noted, however, that the valuation and/or quantification of control rights is not easily performed:
  - •The value of control rights are **not readily and objectively measurable**
  - •The allocation methods **do not typically consider** control rights

Valuation Discounts & Premiums

- Most common are Discount for Lack of Marketability (DLOM), Control Premiums (CP), and Minority Interest Discounts (MID)

- Be careful when addressing discounts and premiums:
  - Serving two masters: IRS and SEC/Auditors
  - Auditors push back on discounts – especially within one year of IPO

- If path is IPO or M&A, then inclusion of control premium and LOC discount is less appropriate than in a 'stay private' path

- Theoretically possible for the IRS & SEC to allow/ disallow different discounts, creating two different values. More to come this later this year……

Issues to Consider

- When should a private company have an external valuation performed?   AICPA *Practice Aide* methods can be difficult, and incorrectly applying them could lead to issues further down the road.

- Coordination of grants w/ valuations or valuation updates

- Significant Events requiring update

- It's a good idea to coordinate valuations w/ Company auditors, so that methodologies and approaches can be agreed on.

409A Action Items

- As a result of the final regulations, companies should perform the following action items within the next several months:
- Review existing equity incentive plan documents and form equity award agreements and amend as necessary to ensure compliance with the final regulations
- Review outstanding equity awards to determine whether they are subject to Section 409A and amend as necessary to ensure compliance with the final regulations.
- Assess whether the company's method for valuing the fair market value of its common stock complies with the final regulations