Chapter 1

Concepts of Fair Value of Equity Securities

1.01 Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 718, *Compensation—Stock Compensation*, and 505-50 provide guidance on how to account for transactions in which an entity exchanges its equity instruments for goods or services. FASB ASC 718 addresses share-based payments to employees, and FASB ASC 505-50 pertains to share-based payments to nonemployees.

1.02 In general, FASB ASC 718 and 505-50 rely on the concept of fair value. Under FASB ASC 718 and 505-50, *fair value* is defined as "[t]he 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."

1.03 That definition refers explicitly only to assets and liabilities, but the concept of value in a current exchange embodied in that definition applies equally to the equity instruments subject to FASB ASC 718 and 505-50. According to paragraphs 10–11 of FASB ASC 718-10-55, observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used as the basis for the measurement of equity and liability instruments awarded in a share-based payment transaction. If observable market prices of identical or similar equity or liability instruments of the entity are not available, the fair value of equity and liability instruments awarded should be estimated by using a valuation technique (such as an option pricing model).

1.04 A valuation performed for the purpose of valuing privately held company securities issued as compensation under accounting principles generally accepted in the United States of America should be based on the definition of *fair value* used in FASB ASC 718 and 505-50. It should be noted that this definition of fair value is slightly different from the definition in FASB ASC 820, *Fair Value Measurement*,[1] in which *fair value* is defined as "[t]he 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."

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[1] Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurement*, guidance included in this guide reflects amendments in FASB Accounting Standards Update (ASU) No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. ASU No. 2011-04, which was issued in May 2011, does not extend the use of fair value accounting but provides guidance on how it should be applied when its use is already required or permitted by other standards. ASU No. 2011-04 supersedes most of the guidance in FASB ASC 820, although many of the changes are clarifications of existing guidance or wording changes to align with International Financial Reporting Standard No. 13, *Fair Value Measurement*. It also reflects FASB's consideration of the different characteristics of public and nonpublic entities and the needs of users of their financial statements. Nonpublic entities are exempt from a number of the new disclosure requirements. ASU No. 2011-04 also provides guidance for measuring the fair value of an instrument classified in a reporting entity's shareholders' equity.

The amendments in ASU No. 2011-04 are to be applied prospectively. For public entities, the amendments are effective during interim and annual periods beginning after December 15, 2011. For nonpublic entities, the amendments are effective for annual periods beginning after December 15, 2011. Early application by public entities is not permitted. Nonpublic entities may apply the amendments in ASU No. 2011-04 early but no earlier than for interim periods beginning after December 15, 2011. Readers should refer to the FASB website for more information.

1.05 FASB ASC 820 establishes a framework for measuring fair value and requires disclosures about fair value measurements. FASB ASC 820 is a broad principles-based standard that applies to all entities, transactions, and instruments that require or permit fair value measurements. However, FASB ASC 820-10-15-2 indicates that the guidance in FASB ASC 820 does not apply to accounting principles that address share-based payment transactions. In particular, the application of fair value in share-based payment arrangements does not factor in vesting provisions and provides for a few other exceptions to fair value (for example, reload features). As such, these measures are considered fair value-based measures rather than fair value measures. Therefore, even though some measurements used within FASB ASC 718 and 505-50 may be fair value measures, for practical reasons, FASB decided to exclude these pronouncements from FASB ASC 820 in their entirety.[2]

1.06 Even though FASB ASC 820 technically does not apply when valuing private company equity securities granted under FASB ASC 718 or 505-50, the fair value concepts in FASB ASC 820, 718, and 505-50 are closely aligned, and the Equity Securities Task Force (task force) believes that the valuation of private company equity securities granted under FASB ASC 718 or 505-50 generally would be consistent with the valuations performed for purposes of FASB ASC 820. Furthermore, the task force believes that FASB ASC 820 contains some concepts that practitioners may find helpful when estimating fair value in connection with share-based payment transactions. Therefore, the task force recommends following the measurement guidance in FASB ASC 820 when accounting for share-based payment transactions unless it is inconsistent with the guidance in FASB ASC 718 or 505-50. For example:

- If stock is restricted from sale to other than qualified institutional buyers under Securities and Exchange Commission (SEC) Rule 144A, the restriction is a characteristic of the equity instrument and, therefore, would be transferred to *market participants*. In that case, under FASB ASC 820-10-55-52, the fair value of the unrestricted equity instrument would be adjusted to reflect the effect of the restriction.
- However, based on guidance in paragraphs 17–19 of FASB ASC 718-10-30, a limited population of transferees is not a prohibition. As such, the value of a nonvested share granted to an employee would not be discounted due solely to the fact that the share could be transferred only to a limited population of investors. Therefore, under the guidance in FASB ASC 718, a restriction under SEC Rule 144A would not be taken into account when estimating the fair value of the securities.[3]

1.07 The definitions of *fair value* used in FASB ASC 718, 505-50, and 820 appear similar to the definition of *fair market value* as defined by the

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[2] FASB explained its rationale for excluding FASB ASC 718, *Compensation—Stock Compensation*, and 505-50 from the scope of FASB ASC 820 in paragraph C8 of FASB Statement No. 157, *Fair Value Measurements*. Paragraph C8 of FASB Statement No. 157 was not codified in FASB ASC; however, the Equity Securities Task Force (task force) believes it provides helpful guidance and, therefore, decided to incorporate it in this guide. Although share-based payment transactions are excluded from the scope of FASB ASC 820, the fair value measurement objective in FASB ASC 718 and 505-50 is generally consistent with the fair value measurement objective in FASB ASC 820.

[3] However, for tax purposes, such restrictions typically are considered in estimating the fair market value of the securities. As such, the valuation of securities under Internal Revenue Code Section 409A may differ from the valuation of such securities under FASB ASC 718.

International Glossary of Business Valuation Terms and IRS Revenue Ruling 59-60. The *International Glossary of Business Valuation Terms* defines fair market value as

> the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

1.08 IRS Revenue Ruling 59-60 defines *fair market value* as "the price at which 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."

1.09 When deliberating FASB Statement No. 157, *Fair Value Measurements*, FASB agreed that the measurement objective encompassed in the definition of fair value used for financial reporting purposes is generally consistent with similar definitions of fair market value used for valuation purposes. However, FASB observed that the definition of fair market value relates principally to assets (property). Further, the definition has a significant body of interpretive case law developed in the context of tax regulation. Because such interpretive case law, in the context of financial reporting, may not be relevant, FASB chose not to adopt the definition of fair market value and its interpretive case law for financial reporting purposes.[4] Thus, when performing dual-purpose valuations for both tax and financial reporting purposes (for example, to value common stock for compliance with Internal Revenue Code [IRC] Section 409A and for financial reporting in connection with FASB ASC 718 or 505-50), it is important to understand the differences in the definitions of fair value and fair market value.

1.10 For minority interests, the unit of valuation is the minority interest, not the overall enterprise. In particular, although all the standards of value discussed previously contemplate a transfer of the asset on the measurement date, the asset to be considered is the minority position. Therefore, the market participant or willing buyer contemplated in the fair value definitions discussed previously is the hypothetical buyer for the minority interest, not a hypothetical buyer for the entire enterprise. Because a market participant who purchases a minority interest in the enterprise would be unable to change the company's strategy, it is appropriate for the valuation to consider the plans of the enterprise under current ownership rather than assuming a sale of the enterprise on the measurement date.

1.11 To increase consistency and comparability in fair value measurements and related disclosures, FASB ASC 820 establishes a fair value hierarchy that categorizes into three levels the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (level 1) and the lowest priority to *unobservable inputs* (level 3). According to FASB ASC 820-10-35-41, a quoted price in an active market provides the most

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[4] The explanation in this paragraph is based on paragraph C50 of FASB Statement No. 157, which was not codified in FASB ASC. However, the task force believes that paragraph C50 provides helpful guidance and, therefore, decided to incorporate it in this guide.

reliable evidence of fair value and should be used without adjustment to measure fair value whenever available, except in circumstances specified in FASB ASC 820-10-35-41C.[5]

1.12 Securities of privately held enterprises, by definition, are not traded in public markets; therefore, quoted prices are generally not available. However, privately held enterprises may sometimes engage in arm's-length[6] cash transactions with *unrelated parties* for issuances of their equity securities, and under certain conditions, the cash exchanged in such a transaction is an observable input. Those conditions are

a. the equity securities in the transaction are the same securities as those for which the fair value is being estimated (for example, when both investors and management hold common stock, and the management shares have the same rights as the investor shares without additional postvesting restrictions), and

b. the transaction is a current transaction between willing parties (that is, other than in a forced or liquidation sale and other than under terms or conditions arising from a previous transaction). (For example, a transaction in which the investors purchase additional shares pursuant to a tranched preferred agreement or when employees exercise employee stock options at a fixed, previously determined price would not satisfy condition [*b*].)

See chapter 8, "Inferring Value From Transactions in a Private Company's Securities."

1.13 Even when these conditions do not apply, any transactions in the company's equity securities would need to be considered when estimating the fair value of the other equity securities in the company, making adjustments as needed.[7] For example, if the company has completed a preferred stock financing round within a relevant time period or is scheduled to complete such a financing within the next few months, the valuation of the company's other equity securities would need to

- consider the differences in rights and preferences between the current financing and the company's other equity securities;
- evaluate the changes in the value of the company between the transaction date and valuation date, if any, or the risk associated with a planned transaction if the transaction has not yet closed; and

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[5] FASB ASC 820-10-35-41C specifies certain circumstances when adjustments to level 1 inputs may be appropriate (for example, in valuing large portfolios of similar assets [for example, using matrix pricing] or making adjustments for factors specific to the asset when relying on the quoted price for an asset in estimating the fair value of a liability).

[6] The meaning of arm's length has varying interpretations in practice. For example, some might consider the sale of preferred stock in a second round of financing to an existing investor a related-party transaction, even if other preferred shares in the same round are sold to new shareholders. A full discussion of this issue is beyond the scope of this chapter, but the reader should be aware that different interpretations of arm's length do exist and should be adequately explored and explained in the valuation report.

Also, FASB ASC 820-10-30-3A(a) provides the following guidance on related party transactions: "[T]he price in a related party transaction may be used as an input into a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms."

[7] See chapter 8, "Inferring Value from Transactions in a Private Company's Securities."

- if the transaction is not arm's length, understand the reasons for the differences between the transaction price and fair value of the securities purchased.

See chapter 8.

1.14 If neither quoted market prices in active markets nor arm's length cash transactions in the same class of securities are available, as is most often the case with privately held equity securities, the task force recommends that management engage a valuation specialist for the purpose of assisting management in estimating the fair value of these securities. Estimating the fair value of the privately held equity securities is the responsibility of management. Management bears the responsibility for investigating the qualifications of a valuation specialist (see appendix C, "Criteria for the Selection of a Valuation Specialist"), engaging the valuation specialist, and ensuring that a high-quality valuation is performed and documented in a report. The assumptions used in estimating the fair value of the privately held equity securities, whether prepared by management or the valuation specialist, are the responsibility of management. Management is responsible for understanding and evaluating the conclusions of the valuation report. See appendix D, "Table of Responsibilities of Management and the Valuation Specialist," for a summary of the various responsibilities of management and the valuation specialist that are discussed in detail throughout this guide.

1.15 All valuation techniques applied in a valuation of a privately held enterprise and its securities may be broadly classified into the market, income, or asset approaches.[8] Each of the three approaches may be applicable in the valuation of privately issued securities, depending largely on the stage of an enterprise's business development. In performing a valuation, a valuation specialist should consider all three approaches and select the approach or approaches that are appropriate under the circumstances.[9] That selection would include consideration of factors such as the history, nature, and stage of development of the enterprise; the nature of its assets and liabilities; its capital structure; and the availability of reliable, comparable, and verifiable data that will be required to perform the analysis. In some cases, a single valuation technique will be appropriate, whereas in other cases, multiple valuation techniques will be appropriate. See chapter 9, "Relationship Between Fair Value and Stages of Enterprise Development," for a discussion of the relationship between approach selection and the stage of enterprise development.

1.16 It is then up to the valuation specialist's informed judgment to assess the results of the various valuation techniques used and to arrive at the fair value measurement. FASB ASC 820-10-35-24B states that "[i]f multiple valuation techniques are used to measure fair value, the results (that is, respective indications of fair value) shall be evaluated considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances." Therefore, when assessing the results of various valuation techniques, the valuation specialist would need to consider factors such as the

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[8] See footnote 9 in paragraph .11.

[9] This requirement is consistent with guidance in paragraphs .31–.32 of Statement on Standards for Valuation Services No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (AICPA, *Professional Standards*, VS sec. 100). It is also consistent with guidance in FASB ASC 820-10-35-24.

relative applicability of the valuation techniques used, given the nature of the industry and current market conditions; the quality, reliability, and verifiability of the data used in each valuation technique; the comparability of public enterprise or transaction data used in the analyses to the subject enterprise; and any additional considerations unique to the subject enterprise.

1.17 For purposes of this guide, a *fairness opinion* does not constitute a fair value estimate, although the analysis used to support the fairness opinion may provide input useful in developing a fair value estimate.

1.18 A best practice is to perform the valuation explicitly for each purpose for which management plans to use the valuation. For example, if management plans to use the common stock valuation both for establishing an option strike price consistent with IRC Section 409A and as an input into estimating the fair value of the options in accordance with FASB ASC 718, the valuation specialist should explicitly consider both purposes and any differences in the valuation required for those purposes. Similarly, if management plans to use the valuation analysis both for estimating the fair value of the common stock in accordance with FASB ASC 718 and estimating the fair value of the preferred stock warrants or other interests in accordance with FASB ASC 820, the valuation specialist should explicitly consider both purposes and any differences in the valuation required for those purposes. Finally, in some cases, investors in the enterprise may rely on an analysis performed for purposes of IRC Section 409A or FASB ASC 718 in estimating the fair value of minority interests in the preferred stock or other securities, as required under FASB ASC 946, *Financial Services—Investment Companies*. Although the valuations required for these various purposes are expected to be generally consistent, it is not appropriate to assume that the valuation performed for one purpose will necessarily be suitable for another purpose.