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Current Valuation Issues

AICPA WORKING DRAFT OF PRACTICE AID "*VALUATION OF PRIVATELY HELD COMPANY EQUITY SECURITIES ISSUED AS COMPENSATION*"

Allocation of Equity Value to Complex Capital Structures

Industry Focus: Digital Media and Technology

Stock Valuation and Equity Compensation

A recent practice aid revision from the American Institute of Certified Public Accountants ("AICPA") provides considerable clarity for the valuation of equity securities. This draft is of critical importance to digital media and technology companies. First, it provides useful guidance for complying with complex financial reporting requirements regarding equity valuation and executive stock compensation. Second, by prescribing more sophisticated and uniform valuation tools, it may enhance economic decision-making by helping companies to more accurately value their assets and different classes of stock.

The analysis of complex capital structures has become increasingly important to privately-held digital media and technology companies. Emerging technology companies are often funded by angel investors, venture capital, and private equity sources. When there are several rounds of financings, the capital structure may become complicated with different classes of preferred and common stock securities, each with its own rights and preferences, as well as warrants, options, employee stock options, stock appreciation rights, and phantom stock. Investors and financial executives need to be kept informed about the current value of their investments and the capitalization structure. In addition, equity compensation plans are a key component of attracting and retaining employees for emerging digital media and technology companies. Companies are required to follow the tax and accounting rules set forth in Internal Revenue Code Section 409A and Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 718, Stock Compensation (formerly FAS 123R) when equity compensation plans are put into place and on an ongoing basis thereafter.

In the Spring of 2011, the AICPA issued a working draft to update the 2004 edition of its Practice Aid, "Valuation of Privately Held Company Equity Securities Issued as Compensation." The purpose of the update is to provide additional guidance in the valuation of complex capital structures. The final version of the update to the 2004 Practice Aid is due to be released by the end of 2012. In the following pages, we summarize key components of the working draft for the updated Practice Aid and discuss the common valuation methods utilized and issues that arise in the valuation of equity securities, warrants, and options.

Stock Valuation

The valuation of a company's capital structure begins with the determination of the fair value of the business enterprise.[1] The enterprise value can be determined by using the cost, market, or income approaches to valuation. The cost approach may be appropriate for a start-up company that does not have a substantial operating history or one that is in a very early stage of development. The market and income approaches are generally employed to determine the value of a media or technology business in the later stages of development.

Cost Approach

The cost approach establishes the value of a company by summing the total fair value of its assets or the investments made to date in establishing the business. These assets can include both tangible and intangible assets. This method may not be the most useful approach for the valuation of digital media and technology companies because the most valuable assets of these firms are often in the form of intangible assets (software, licenses, patents, intellectual property, customer relationships, trademarks, etc.). If these assets are generating revenues or profits, their value may bear little resemblance to their cost. However, the approach may be useful in the valuation of start-up companies with no operating history and a limited number of comparable peer companies.

Market Approach

The market approach, also known as the comparative sales or comparable sales method, establishes business values by comparing the traits of the subject business with those of companies or properties which are known to have been sold. For privately-held emerging media and technology companies, it is often challenging to obtain detailed financial information about recent comparable sales. In many cases,

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[1] Under Financial Accounting Standards Board ("FASB") Accounting Standards Codification 820 ("ASC 820"), Fair Value is defined 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."

detailed financial information is not disclosed for private transactions even when a company is acquired by a publicly-held buyer. Where data is available, it is important to make sure that the acquired businesses are comparable in the type of market served, their product or service, size, and profitability.

In transactions where the revenue and operating cash flow of the target company is disclosed, revenue and cash flow valuation multiples can be developed. The average and median valuation multiples of the comparable businesses can be applied to the subject company's revenues and operating profits to determine an implied enterprise value. Under this approach, the valuation must consider the stage of development of the subject company. As is often the case with developing businesses, the revenues may be growing rapidly and there may be operating losses in the early years of operations. Applying a steady-state stage or more mature valuation multiple to the subject company's financial performance may not capture the firm's potential or fair value.

In addition to comparable sales transactions, it is helpful to look at the market capitalizations and enterprise values of similar publicly-traded companies to determine relevant valuation multiples.

Income Approach

The income approach in the form of a discounted cash flow model incorporates variables such as revenue projections, operating expenses, capital expenditures, working capital, and discount rates. The variables reflect historical and expected market growth trends and will capture future firm growth.

The time horizon of the cash flows should match the time to the liquidity event. In the valuation of a company as a "going concern", a discounted cash flow projection period of five to ten years is considered to be an appropriate time horizon for the analysis. Although certain investors may expect to recover their investments within five years, it is important that the projections begin to reflect the subject company's growth rate at a more mature, developed stage.

Key variables in the income approach include the company's revenue and expense growth rates, future capital expenditures, and discount rates. The revenue and expense growth rates should be tested against industry benchmarks. A discount rate, used to adjust the subject company's cash flow to present value, is usually based upon a weighted average cost of capital. Since many emerging digital media and technology companies have little debt in their capital structures, the rate is primarily dependent upon the cost of equity. This rate can vary widely depending upon marketplace parameters and the stage of development. At the most early stages, these rates can reflect the high return expectations of angel investors and venture capitalists. As the business develops, the rates are reflective of private

equity requirements and, eventually, standard equity rates derived from the current market rates and betas of comparable later-stage guideline companies, based upon the size and nature of the subject company.

Once the enterprise value is determined, the value is adjusted for cash and cash equivalents and debt to determine the value of 100% of the equity that is available to shareholders. The value of the cash and cash equivalents are added and the fair value of the interest bearing debt is subtracted from the enterprise value. Certain preferred stock may have debt-like characteristics such as payment of a dividend, return of capital, mandatory redemption rights, or no ability to participate in future rounds of financing. For a privately-held firm, it is unlikely that the debt is traded. In this case, the fair value of the debt can be determined by using a discounted cash flow analysis (yield method) or reflected in the allocation model as a zero-coupon bond equivalent.

Classes of Stock

Emerging digital media and technology companies are often capitalized with several different classes of securities. Angel investors and venture capital companies are typically early investors and take on considerable risk with investments in early stage companies. These firms and individuals may require a combination of guaranteed returns and the ability to participate in capital appreciation based upon a liquidity event. Companies often issue preferred stock to early investors that carry various rights and preferences. Subsequent funding may come from private equity investors that may layer additional classes of preferred and common stock into the company's capitalization structure. Common stock is also reserved for investors and key executives alike. In addition, equity compensation plans may include stock options, stock appreciation rights (SARs), employee stock purchase plans, grants and warrants, and restricted stock.

Stock valuations, given the potential complexity imbedded in the securities, require special sensitivity to applicable rights and restrictions. These limitations may result in the consideration of certain adjustments for lack of control, liquidity and marketability, and voting rights. Certain economic rights may include preferred dividends, liquidation preferences, mandatory redemption rights, conversion rights, participation rights, anti-dilution rights, and registration rights. Control rights can include voting rights, super-voting rights, veto rights, board participation, drag-along rights, and first refusal rights.

Equity Allocation Methods

As discussed previously, companies generally issue two types of stock: common and preferred. Where there are multiple classes of stock, the equity is allocated among the various classes of securities based upon the rights and preferences afforded to each type of security. There are four equity value allocation methods that are commonly used. The methods include the Probability-Weighted Expected Return method (PWERM), the option-pricing method, the current-value method, and the hybrid method. Given that the allocation of equity value is complex and varies from company to company, none of the four methods are superior or capture the economic benefits attributable to every particular right or preference.

Probability-Weighted Expected Return Method

The allocation of equity value using PWERM is based upon projecting a set of future enterprise values under several different scenarios.[1] These scenarios may include future liquidity events such as an initial public offering (IPO), sale, merger, dissolution, or continuing operation as a privately-held business. These future enterprise values, adjusted to equity value, are allocated among the various classes of stock based upon their respective rights and preferences. The future equity values are weighted based upon the estimated probability of the occurrence of each liquidity event and then discounted back to present value. If appropriate, discounts for lack of control or marketability would be applied at this point. An illustration of the PWERM model is shown in Exhibit A.

The application of PWERM takes into consideration a variety of possible future economic prospects for the subject company and allocates equity value based upon the various rights and preferences of company stock, options, and warrants. However, as is the case in any projections of future events, assumptions such as the probability weighting, timing to the liquidity event, and calculation of the discount rate can be subjective and significantly affect the outcome of the analysis.

Option-Pricing Method

According to the AICPA 2011 Practice Aid, this method "…treats common stock and preferred stock as call options on the enterprise's equity value with exercise prices based upon the liquidation preference at the time of a liquidity event…" In effect, the common stockholders will have the right to a portion of the residual equity

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[1] The 2011 Practice Aid indicates that the "Backsolve Method," which is a form of the market approach, can be used to determine the equity value of the business. The approach is based upon examining a recent financing from one of its own securities and calculating the implied value of the company's equity.

value once any preferred stockholders receive their preferences. If the preferred stock is convertible, the analyst needs to determine the point at which the preferred shareholders would make the economic decision to convert to common stock. The Black-Scholes option pricing model or another binomial model may be utilized under this valuation method.

The Option-Pricing model assumes a future liquidation scenario and takes into account the rights and preferences of each of the classes of securities. Depending upon the option model used, model variables will include the current equity value, effective exercise price, volatility, time to liquidation event, and risk-free rate. The variables associated with the Black-Scholes model are described in detail below:

Equity Value – Once the likely form of the liquidation event is assessed, the cost, market, or income approach can be used to determine the current enterprise value of the company. The estimated current enterprise value is adjusted for cash and cash equivalents and interest-bearing debt to calculate the fair value of the equity.

Exercise Price – The exercise price is based upon strike prices, liquidation preferences, and an as-converted waterfall analysis for each class of preferred and common stock. The waterfall analysis determines the equity value at which each class of stock, option, or warrant would begin to receive equity proceeds. This is commonly known as the "breakpoint."

Volatility – For a privately-held company, there is typically no data to compute the volatility of the firm's equity. Publicly-held guideline companies can be used to determine the volatility factor. However, since the resulting value of the equity in the option model is sensitive to this assumption, it is important to give careful consideration to the peer company stock prices and how the subject company relates to the comparable firms.

Time – The fixed or estimated time to the liquidity event.

Risk-Free Rate – The risk-free interest rate can be based upon current Treasury bill rates. The time period of the Treasury bills should match the time period between the valuation date and the liquidity event.

Once the value of the preferred and common stock is determined, it may be appropriate to consider the application of discounts for lack of control or marketability depending upon the characteristics of the stock. A simple illustration of the option model is shown in Exhibit B where the equity value of the company is estimated to be $15,000,000 using the income method in the form of a discounted cash flow approach.

The AICPA taskforce suggests that the Option-Pricing method is the best method to utilize when it is challenging to forecast the projected liquidity event. This method limits the practitioner to the selection of a single most-likely liquidity event.

Current Value Method

The valuation of equity under the Current Value method is based upon the enterprise value of the company as of the valuation date. The enterprise value is determined using the cost, market, or income methods. After adjustments for cash and cash equivalents and debt, the equity value is allocated to the preferred and common stock with consideration to their various rights and preferences. It is assumed that the preferred shareholders will take advantage of the best economic outcome available which may include converting their shares to common stock at the time of the valuation. If applicable, discounts for lack of control and marketability are applied.

The Current Value method is simple in its application but has certain drawbacks. The method does not take into consideration the variety of possible future liquidity events and is thus most relevant when a liquidation event is close at hand. The AICPA taskforce indicates that it is also useful where 1) a company is in the early stages of development and has demonstrated little growth and 2) value has not yet been created for the common shareholders above the preferred shareholders' liquidation preferences.

Hybrid Method

The Hybrid method makes use of both the PWERM and Option-Pricing method within a valuation. The Option-Pricing method might be used and weighted for probability where there are contingent outcomes. For example, if the company requires a new round of financing, the liquidity options of the business may change depending upon whether the financing goes through or not. In addition, the rights and preferences of the financing may dictate different exit strategies.

Conclusion

The AICPA released the updated draft of the 2011 Practice Aid to express its views on the best valuation practices for privately-held company classes of securities. The guide highlights the complexity associated with selecting a valuation method and determining the value of the equity of a privately-held company. Likewise, there are challenges when choosing an allocation method and selecting the reasonable assumptions to allow the allocation of the equity value across complex capital structures.

These complexities are particularly evident for companies in the digital media and technology sectors. There are a number of emerging growth companies within these industries with little or no operating history and others that are expanding at extraordinarily high rates of growth. Companies in the start-up and high growth phase are difficult to value and often require the application of a number of different valuation methods and scenarios to develop the fair value of the equity. Similarly, technology firms are known to have layers of complex securities in their capitalization structures due to numerous rounds of investment from angel investors, venture capital, private equity, and other sources of capital. Also, company equity is often used as an incentive to attract talented employees, leading to stock options, warrants, stock appreciation rights, phantom stock, and similar plans used in employee compensation. As a result, the allocation of company equity to various classes of securities is a time consuming and complex task. Given these facts, financial executives and investors in privately-held digital media and technology companies should understand the most recent guidance on this topic to ensure that their current tax and accounting practices are consistent with industry standards and meet the required regulations. Experienced and independent valuation professionals are often required to meet the rigorous standards surrounding equity valuation and employee compensation.

Bond & Pecaro, Inc. will continue to provide updates on this issue. Please contact Jeff Anderson of the firm at 202-775-8870 with any questions or requests for additional information.

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EXHIBIT A

Probability-Weighted Expected Return Method
(Dollar Amount in Thousands, Except Per Share Amounts)

Security	Date Issued	Number of Shares	Value/Share	Liquidation Value	Conversion Ratio
Common Stock	01/01/2011	7,000		$0	
Series A Convertible Preferred Stock	06/30/2011	2,000	$1.00	2,000	1:1
Series B Convertible Preferred Stock	01/01/2012	1,000	$1.00	1,000	1:1
Total		10,000		$3,000	

	1	2	3	4
Liquidation Scenario (3 Years)	IPO	Sale-High	Sale-Low	Dissolution
Probability of Occurrence	15.0%	50.0%	30.0%	5.0%
Projected Equity Value at Liquidity	$25,000	$20,000	$15,000	$2,500
Less: Series A Convertible Preferred Stock Preference[1]	0	0	0	2,000
Less: Series B Convertible Preferred Stock Preference[3]	0	0	0	500
Residual Equity Value	$25,000	$20,000	$15,000	$0
Allocation of Equity Value				
Series A Convertible Preferred Stock	$5,000	$4,000	$3,000	$2,000
Series B Convertible Preferred Stock	2,500	2,000	1,500	500
Common Stock	17,500	14,000	10,500	0
Total	$25,000	$20,000	$15,000	$2,500

[1] Assumes conversion to common stock.

EXHIBIT A
(continued)

	1	2	3	4
Liquidation Scenario (3 Years)	IPO	Sale-High	Sale-Low	Dissolution
Probability of Occurrence	15.0%	50.0%	30.0%	5.0%
Weighted Equity Value: Series A				
Probability Weighted Equity Value	$750.0	$2,000.0	$900.0	$100.0
Total Weighted Equity Value				$3,750.0
Present Value of Weighted Equity Value @ 12%				$2,669.2
Number of Shares Outstanding				2,000
Fair Value: Series A Preferred Stock				$1.33
Weighted Equity Value: Series B				
Probability Weighted Equity Value	$375.0	$1,000.0	$450.0	$25.0
Total Weighted Equity Value				$1,850.0
Present Value of Weighted Equity Value @ 12%				$1,316.8
Number of Shares Outstanding				1,000
Fair Value: Series B Preferred Stock				$1.32
Weighted Equity Value: Common Stock				
Probability Weighted Equity Value	$2,625.0	$7,000.0	$3,150.0	$0.0
Total Weighted Equity Value				$12,775.0
Present Value of Weighted Equity Value @ 12%				$9,093.0
Number of Shares Outstanding				7,000
Fair Value: Common Stock				$1.30
Less: Discount for Lack of Marketability				35%
Fair Value (Non-marketable): Common Stock				$0.85

EXHIBIT B

Option-Pricing Method

(Dollar Amount in Thousands, Except Per Share Amounts)

Allocation Method: Option-Pricing

Security	Date Issued	Number of Shares	Value/Share	Liquidation Value	Conversion Ratio
Common Stock	01/01/2011	7,000		$0	
Series A Convertible Preferred Stock	06/30/2011	2,000	$1.00	2,000	1:1
Series B Convertible Preferred Stock	01/01/2012	1,000	$1.00	1,000	1:1
Total		10,000		$3,000	

Breakpoint Analysis		**Breakpoint**	**1**	**2**	**3**	**4**
	Shares	Starting Value	$0 -	$2,000	$3,000	Over
Security	Outstanding	Ending Value	$2,000	$3,000	$10,000	$10,000
Series A Convertible Preferred Stock	2,000		100.0%	0.0%	0.0%	20.0%
Series B Convertible Preferred Stock	1,000		0.0%	100.0%	0.0%	10.0%
Common Stock	7,000		0.0%	0.0%	100.0%	70.0%
Total	10,000		100.0%	100.0%	100.0%	100.0%

EXHIBIT B
(continued)

Black-Scholes Option Model: Assumptions

Value of Company Equity	$15,000
Volatility	50.0%
Time to Liquidity Event (Yrs.)	3.0
Risk Free Rate	0.36%

			1	2	3	4
Security	Value/ Share	Allocated Value	$0 $2,000	$2,000 $3,000	$3,000 $10,000	Over $10,000
Series A Convertible Preferred Stock	$1.6980	$3,396	$1,964	$0	$0	$1,432
Series B Convertible Preferred Stock	1.6554	1,655	0	939	0	716
Common Stock	1.4212	9,949	0	0	4,937	5,011
Total		$15,000	$1,964	$939	$4,937	$7,159

	1	2	3	4
Exercise Price of Option	$0	$2,000	$3,000	$10,000
Black-Scholes Option Value	$15,000	$13,036	$12,096	$7,159
Incremental Black-Scholes Option Value	$1,964	$939	$4,937	$7,159

Security	Value/ Share (Marketable)	Less: DLOM	Value/ Share (Non-Marketable)
Series A Convertible Preferred Stock	$1.70	--	$1.70
Series B Convertible Preferred Stock	$1.66	--	$1.66
Common Stock	$1.42	35.0%	$0.92