Armanino^{LLP} Welcomes You To Today's Webinar:

The Importance of 409A and Equity Awards for Growing Companies

The presentation will begin in a few moments

Participants will receive an email within 3 business days with access to their certificate of completion.

About the Presenters

Dirk Van Dyke, MSBA, ASA

Managing Director, Valuations & Consulting at Armanino

Dirk focus is on Valuations for technology companies:

- 20 years of experience in Silicon Valley
- ASA in Business Valuation
- Member, Fair Value Forum
- Masters of Science in Business Administration from UC Berkley

His major practice areas include:

- Common stock valuations for option pricing for IRS Code Section 409 (A) and FASB ASC 718 (formerly FAS123R)
- Purchase price allocation valuations FASB ASC 805
- Valuations for M&A including shareholder buy-outs

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About the Presenters

Scott Schwartz

Manager, Equity Management Solutions

Scott has worked in the legal and financial industries, providing financial and consulting services to public and private companies, as well as entrepreneurs.

- Extensive experience in Equity Compensation and Valuations
- Scott works with finance executives on their stock-based compensation and other equity transactions.
- He has completed various specialized training in business valuations, fraud, equity compensation administration and more

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Learning Objectives

During today's webinar, participants will:

- Review the basics of 409A valuations and their importance in equity compensation
- Identify the stages of enterprise development and related valuation methods and typical equity awards
- Recognize the differences and similarities between common stock valuations and option valuations
- Review strong granting practices and issuance considerations to avoid future audit/SEC/IRS issues related to equity compensation

Presentation Overview

- Stages of Enterprise Development and Common Award Types
- Valuation Process
- Valuation Approaches for Different Development Stages
- Equity Granting Process
- Impact of Valuation Timing on Equity Awards

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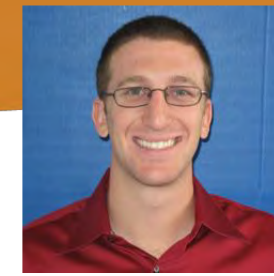
Importance of Common Stock Valuations



- **IRS**
  - Liquidity event
  - Option Exercises
  - Restricted Stock Vesting
  - Cheap Stock
- **Audit/Accounting**
  - ASC 718 – Stock Based Compensation
  - ASC 260 – Earnings per Share
  - ASC 740 – Income Taxes
- **Company Management**
  - Understanding Company’s worth
  - Leveraging the compensation value
  - Knowing personal wealth??

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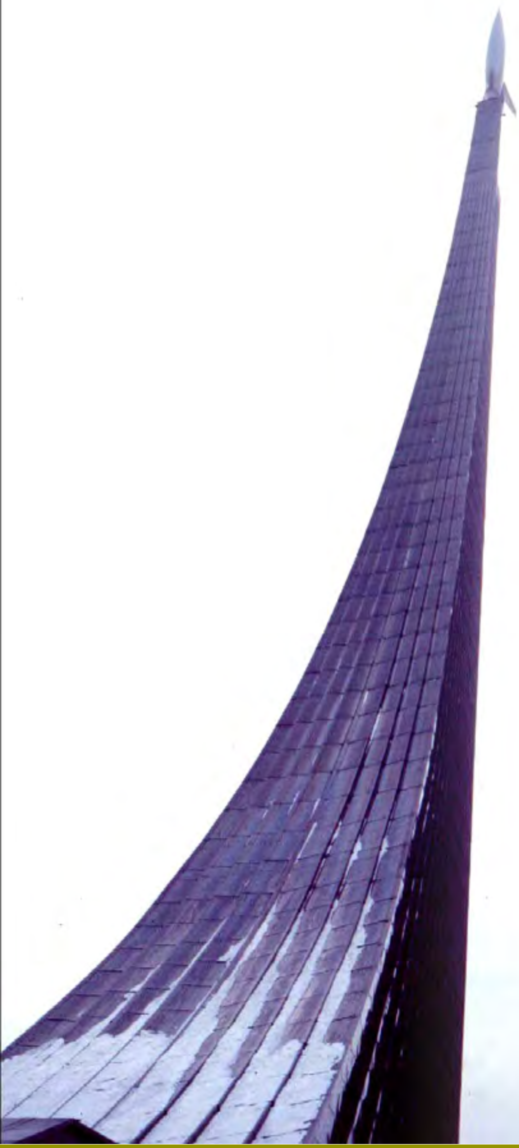
Stages of Enterprise Development

Stock Valuation Guidance – AICPA Valuation Guide

- Accounting & Valuation Guide: Valuation of Privately-Held Company Equity Securities Issued as Compensation
  - Issued in 4th Quarter of 2013
  - Replaced the below
- AICPA Practice Aid on Valuation of Privately-Held Company Equity Securities Issued as Compensation
  - First issued in 2004

Impact of Stage of Development



- Stage of Development Impacts
  - Time to liquidity
  - Discount rate
  - Valuation Methods
- Peer Group Selection

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Enterprise Development: Stage 1 & 2

Stage	Description
1	• **No product revenue to date** • **Limited expense history** • Incomplete management team with an idea/plan • Often great engineers, no sales/marketing people • Seed capital or first-round financing (preferred stock)
2	• **No product revenue** • **Substantive expense history** • Second or third round of financing • Investors are venture capital firms • VCs may provide additional management

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Enterprise Development: Stage 3 & 4

Stage	Description
3	• Made significant progress in product development • Met key development milestones • **Development is near completion** • **No product revenue** • Later rounds of financing • Investors are venture capital firms and strategic business partners
4	• Met additional key development milestones • **Some product revenue** • Later rounds of financing • Discussions may start with investment banks for an IPO

Enterprise Development: Stage 5 & 6

Stage	Description
5	• Has **product revenue** • Breakthrough such as **operating profitability** or **breakeven or positive cash flows** • *An acquisition or IPO* could occur • Outstanding preferred converting to common upon an IPO
6	• **Financial history of profitable operations** or generation of positive cash flows • May remain private • IPO could also occur during this stage

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Peer Group Selection

- Public companies that are comparable in:
  - Industry
  - Markets companies sell into
  - Risk
  - Stage of Development

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General Equity Types and Stages

General Types of Equity Awards

- Stock Options
- Restricted Stock Awards/Units
  - Founder's Stock
- Stock Appreciation Rights
- Time/Service-Based Awards
- Performance/Milestone Awards
- Cash-Settled Awards

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Stock Options

- Throughout all stages
- Most common form of equity compensation
- Easier to administer
- Harder to value
- Performance options are even more difficult to value, and track ISO/NSO split

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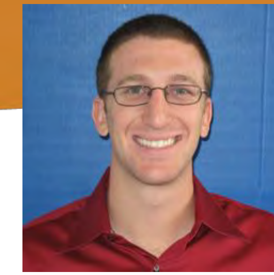
Restricted Stock

- Stage 1 and 4 - 6
  - Early stage
  - IPO
- Founder's Stock
  - Restricted and unrestricted
- Easiest to value (FMV = FV)
  - High Stock-based comp expense
- Difficult to administer (taxes)

Stock Appreciation Rights



- Stages 5 & 6
- More common in mature companies
  - Incentivizing further value appreciation
- Most often cash-settled

Processes and Valuation Approaches

The Valuation Process

- Industry Research, Analysis of Financials, Review of prior Valuation
- Management Interview
- Methodology Selection
- Peer group research/selection
- Draft Valuation
- Review of Assumptions
- Finalize the Process
  - Full Report
  - Auditor Review and Sign-off
  - Board approves new value

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Research and Analysis

- General Industry/Market
- Company-Specific
  - Business model
- Important Financial Metrics:
  - Revenue growth
  - Profitability
- Review of prior year's values and/or methods used
  - Commonly overlooked

Management Interview: Factors Discussed

- Milestones achieved
- State of industry and economy
- Members of management
- Competition
- Barriers of entry
- Existence of proprietary technology, product & service
- Workforce
- Customers
- Strategic relationships with suppliers
- Major investors
- Cost structure and financial condition
- Attractiveness of industry segment
- Risk factors

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Methodology

Income Approach
- Discounted cash flow method
- Capitalization of earnings method

Market Approach
- Guideline public company method
- Guideline merger & acquisition method
- Back solve method

Asset Approach
- Cost
- Appraised Value

Methodology

Relationship Between Fair Value Determination and Stages of Enterprise Development

Valuation Approach	Stages of Enterprise Development
Market	• Used in Stages 3 – 6 • Not used in Stage 1 and 2 • Backsolve Method: All Stages
Income	• Used in later-stage enterprises (i.e., Stages 4-6) • May be appropriate in Stage 2 and 3 with a relatively high discount rate
Asset	• Used in Stage 1 and some enterprises in Stage 2 (asset accumulation method). • Less appropriate once an enterprise has generated significant intangibles and internal goodwill

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Methodology

Stages of Enterprise vs. Valuation Methodology/Weighting

Stage	Income Approach	Market Approach[1]	Back-solve	Cost Approach
1	NA	NA	1	2
2	2	NA	1	NA
3	2	NA	1	NA
4	**2** - 3	2 - **3**	1	NA
5	1-3	2-3	**1** - 3	NA
6	1-3	1-3	**1** - 3	NA

[1] GTM is often given less weight due to perceived lack of information.

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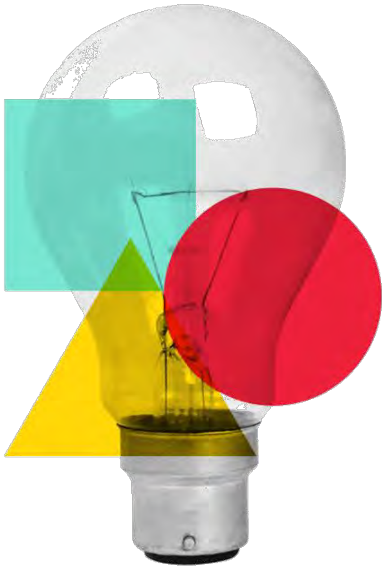
Methodology: Equity Value Allocation

Four equity value allocation methods:

1. Probability-Weighted Expected Return Method (PWERM)
2. Option-Pricing Method (OPM)
3. Current-Value Method
4. Hybrid Methods (mix of the above)

Methodology: Hybrid Methods



- Use a hybrid of two or more methods
- When to use

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Review Process

- Draft Valuation
- Review of Key Assumptions

Finalize the Process

- Common Mistakes
  - No report, or a boilerplate only report
  - Approving common stock value without getting auditors' buy-in on valuation
- USPAP Compliant Report
- Bring auditor's into the process
  - Review
  - Ask questions (discussion if necessary)
  - Sign-off
- Board approval of an audit-ready valuation report

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The Equity Granting Process

1. Have a documented process in place applicable to all stakeholders
   - HR, Payroll, Finance, Legal, Tax, etc.

2. Ensure proper controls so that grants in employee offer letters are presented to the BOD for approval.

3. BOD minutes specifically state:
   - Legal name of the recipient
   - Exercise (strike) price
   - Vesting schedule and vesting dates
   - Special Terms

The Equity Granting Process (cont.)

4. Reconcile BOD minutes to stock ledger reports to ensure all grants are included.

5. Document communication of grants to participants and include the stock option plan, the stock option agreement, and a sample exercise notice.
    - Require recipient acceptance of award
    - Need follow up process

Valuing Equity Awards

- Restricted Stock
  - Intrinsic Value (i.e. Fair Market Value = Fair Value)
- Options/SARs
  - Black-Scholes
  - Lattice
  - Monte-Carlo

Accounting for Grants

Accounting method	Black-Scholes	Lattice/Monte-Carlo
Typical uses	Time vested	Performance
Iterative approach		X
FMV on grant date	X	X
Exercise price	X	X
Expected term	X	X
Volatility	X	X
Dividend rate	X	X
Risk-free interest rate	X	X

Document the reason for the accounting method and the calculation of each input for each grant or similar grants

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Option & Common Stock Valuations

- Don’t simply use same Black-Scholes assumptions for both
  - Option Expected term is typically longer than time to liquidity
    - SAB 107 or historical rate
  - Longer expected term impacts volatility and risk-free rate
- Use the same peer group
  - “Consider: Industry, stage of life cycle, size, and financial leverage”
  - However, amount of trading history may be important

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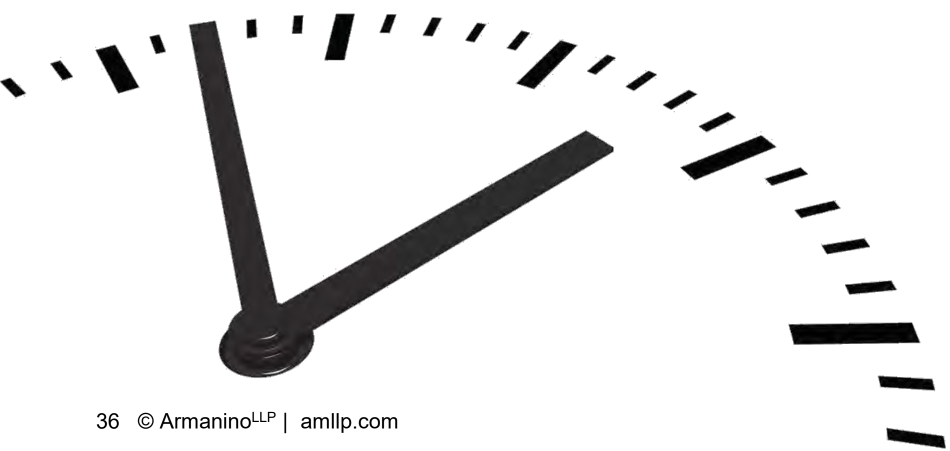
Timing and Impact

Timing & Reliability of Valuation

- Management employs third-party appraiser/valuation specialist to document fair value measurements
- IRS applies the most scrutiny to internally prepared 409A valuations
- Contemporaneous valuation done by independent firm is ideal



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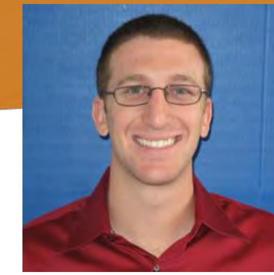
Valuation Timing: Impact on Equity



- Infrequent valuations or granting too near next valuation date
  - No substantiation of value appreciation between grant date and valuation date
  - Different values for tax and GAAP purposes
  - Interpolate FMVs for GAAP purposes
  - Cheap stock for Stock-based compensation purposes
  - Financial Statement/S-1 Disclosure
  - Potential deferred comp penalties for participants

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In Conclusion…

During this webinar, we've covered:

- 409A methodologies and approaches
- The stages of enterprise development and commonly associated equity awards
- Granting and valuing equity awards
- Implications of timing of valuations on equity awards

What Questions Do You Have?

Submit Your Questions Now!

Armanino LLP Certified Public Accountants & Consultants

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