



IRC 409A & ASC 718 Valuations

Stock Option Fair Market Value | Accredited Business Appraisals by Intelék

For private companies granting equity compensation to employees and advisors, compliance with Internal Revenue Code Section 409A is not optional. Intelék's accredited valuation specialists deliver audit-ready, 409A-compliant valuations that provide the Safe Harbor protection your employees need – defensible against IRS challenge and built to withstand Big Four auditor scrutiny.

[INTELEKBUSINESSVALUATIONS.COM](https://www.intelekbusinessvaluations.com)

Why 409A Valuations Matter

The IRS requires that the exercise price of stock options be set at no less than the **Fair Market Value (FMV)** of the underlying common stock on the grant date. Getting this wrong carries severe consequences – not for the company, but for your employees. A stock option granted below FMV is considered "non-compliant deferred compensation," triggering immediate income recognition, a 20% federal penalty tax, plus potential state penalties and interest.

Employee Risk

Immediate income recognition, 20% federal penalty tax, state penalties, and interest – a financial disaster for option holders.

Company Risk

Withholding failures, audit exposure, and the potential to derail future financing rounds or exit events during due diligence.

The Solution

An accredited, independent appraiser delivering a Safe Harbor 409A valuation is the single most important safeguard for your equity program.

IRS SAFE HARBOR

The 409A Safe Harbor — Protection Through Process

The IRS regulations provide a "**Rebuttable Presumption of Reasonableness**" (Safe Harbor) for private company valuations. If a company relies on a Safe Harbor valuation, the IRS bears the burden of proving the valuation is "grossly unreasonable" — a very high bar.

To qualify for Safe Harbor protection, the valuation must be performed by a **qualified independent appraiser**, use consistent and accepted valuation methodologies, and be updated at least every **12 months** — or sooner if a "material event" occurs. Material events include new equity financings, M&A activity, significant operational changes, and secondary transactions.

Key Material Events Triggering a New 409A

New Equity Financing

Raising capital at a new valuation – whether an up-round or down-round – establishes a new arm's-length price that immediately voids the prior 409A.

M&A Activity

Receiving a term sheet or entering exclusivity is a material event requiring an updated valuation before any additional options can be granted.

Significant Operational Changes

Major product launches, loss of a key customer, regulatory approval (e.g., FDA), or a pivot in business model all require a fresh analysis.

Secondary Transactions

Employees or early investors selling shares to third parties can create a new reference price the IRS will scrutinize against your 409A figure.



Step 1 — Determining Enterprise Value

A 409A valuation begins with estimating the total value of the company using a combination of approaches tailored to your stage of development. We apply the methodology most reflective of economic reality at your specific lifecycle stage.

📄 **⚠️ Important:** For venture-backed companies, the Backsolve Method (Market Approach) is often the most reliable indicator of value — consistent with the AICPA Accounting and Valuation Guide. We match methodology complexity to your company's stage so you are never over- or under-served.

VALUATION METHODS

Enterprise Value Approaches

We determine total equity value using the approach best suited to your company's stage. For early-stage companies, the **Backsolve Method** derives value from the most recent preferred financing. For later-stage companies, **Guideline Public Company multiples** (EV/Revenue, EV/EBITDA) are applied to your financial metrics.

For companies with predictable revenue, the **Discounted Cash Flow** method projects future performance discounted to present value. For very early pre-revenue companies, the **Asset Approach** anchors value to the cost to recreate the technology or net asset value.



Step 2 — Allocation of Value to Common Stock

Once Enterprise Value is established, it must be allocated across the complex capital structure (Preferred vs. Common) to determine the value of a single common share. The method chosen depends on your company's stage and exit visibility.

- **OPM:** Industry standard for early-to-mid-stage companies; treats equity classes as call options
- **PWERM:** Used for later-stage companies with clear exit scenarios (IPO, M&A)
- **Hybrid Method:** Combines OPM and PWERM when near-term financing or exit exists with significant remaining uncertainty
- Accounts for liquidation preferences, participation rights, and conversion features

OPM

Early-Stage

Option Pricing Method for
uncertain exit timing

PWERM

Later-Stage

Scenario-weighted exits: IPO,
M&A, stay private

Hybrid

Mixed Outlook

OPM + PWERM for near-term
possibility with uncertainty

Step 3 — Discount for Lack of Marketability (DLOM)

Private company stock is illiquid – an investor cannot sell it on a public exchange. Therefore, a **Discount for Lack of Marketability (DLOM)** is applied to the common share value to reflect this real economic constraint.

We don't use "rule of thumb" discounts. We utilize **quantitative models** (such as the Chaffe or Finnerty put option models) and consider qualitative factors like restrictions on transfer, holding period expectations, and company volatility. Typical DLOMs range from **20% to 35%** but must be specific to your facts and circumstances.

Quantitative Models

Chaffe and Finnerty put option models provide a defensible, mathematically grounded estimate of the cost of illiquidity.

Qualitative Factors

Transfer restrictions, expected time to a liquidity event (IPO or sale), and company-specific volatility all influence the final DLOM.

Typical Range

DLOMs for private companies typically fall between 20%–35%, but every discount must be calculated specifically for your company's facts.

ASC 718 — Financial Reporting for Stock Compensation

- 1 Expense Recognition**

Under ASC 718, companies must recognize the fair value of stock options as a compensation expense on the income statement, typically amortized over the vesting period of each award.
- 2 Cheap Stock Scrutiny**

Auditors and the SEC (for pre-IPO companies) scrutinize the gap between 409A value and the ultimate IPO price. An aggressively low 409A without support can force a restatement of financial statements.
- 3 Volatility Assumptions**

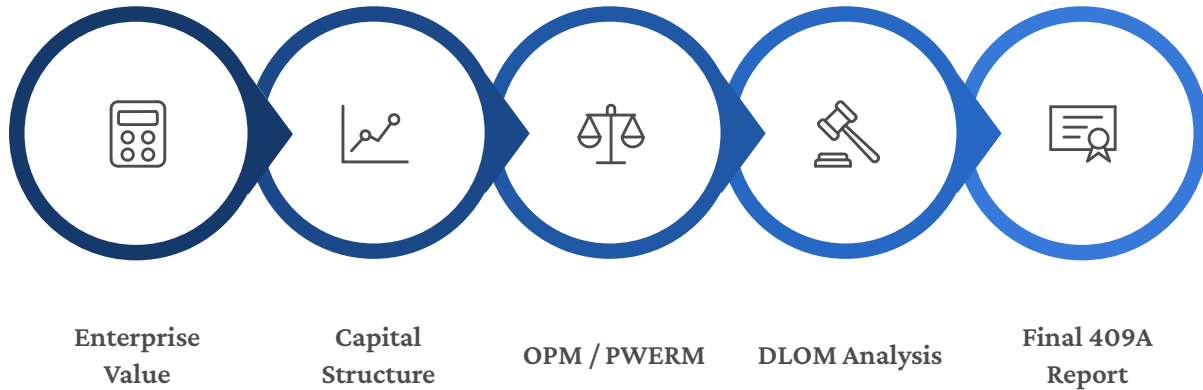
For ASC 718 expense calculations, we assist in estimating expected stock price volatility using peer group data and the expected term of options via the simplified method or historical exercise data.
- 4 Dual Purpose of the 409A Report**

The same 409A valuation used for tax compliance also supports the grant-date fair value used to calculate stock-based compensation expense in your GAAP financial statements under ASC 718.
- 5 Black-Scholes & Lattice Models**

The 409A-determined common stock value feeds directly into the Black-Scholes or lattice model used to compute ASC 718 compensation expense — ensuring financial reporting accuracy that withstands audit.

InteleK's 409A & ASC 718 Approach

Our accredited appraisers deliver thousands of 409A valuations annually for companies ranging from 2-person startups to late-stage unicorns. Every report is built to withstand IRS examination and Big Four audit scrutiny.



Our proven five-step process moves from enterprise value determination through capital structure allocation and DLOM quantification – culminating in an audit-ready Safe Harbor report.



What Sets InteleK's Process Apart



AICPA Guide Compliance

Our methodologies strictly follow the AICPA Accounting and Valuation Guide: Valuation of Privately-Held-Company Equity Securities Issued as Compensation – the exact playbook auditors use to review your valuation.



Audit-Defensible Reports

We document the selection of guideline companies, derivation of the discount rate, volatility analysis, and DLOM calculation – giving auditors and acquirers everything they need to validate the analysis.



Stage-Appropriate Methodologies

We don't over-engineer a valuation for a seed-stage company, and we don't under-serve a pre-IPO company. OPM and PWERM complexity is scaled to match your company's lifecycle stage.



Secondary Transaction Analysis

We have deep expertise evaluating secondary sales and tender offers to determine their impact on 409A value – navigating the tension between employee liquidity and low strike prices for new hires.



Collaboration With Your Advisory Team

InteleK doesn't work in isolation – we work **alongside your advisory team** to ensure the 409A valuation integrates seamlessly into your equity compensation program, financial reporting, and any pending financing or exit process.

→ **Outside Counsel & Employment Attorneys**

We coordinate with legal counsel to ensure valuations support option plan design, grant documentation, and board approval processes.

→ **CPAs & Auditors**

Our reports are structured to integrate directly with ASC 718 expense calculations and support Big Four audit review – reducing friction and improving filing defensibility.

→ **Investment Banks & VC Firms**

We provide the independent, accredited valuation opinion that investors, lead counsel on financing rounds, and M&A advisors require for equity compensation compliance and due diligence.

409A & ASC 718 Compliance: Key FAQs

Expert insights into 409A compliance, Safe Harbor protection, stock option pricing, and ASC 718 expense recognition in 2026.

What is the "Safe Harbor" and why do I need it?

The IRS Safe Harbor (Rebuttable Presumption of Reasonableness) shifts the burden of proof to the IRS. If you rely on a Safe Harbor valuation from a qualified independent appraiser, the IRS must prove the valuation is "grossly unreasonable" to challenge it. Without it, the burden is on you.

Does a new funding round trigger a new 409A?

Yes. A new equity financing round is almost always a material event because it establishes a new arm's-length price. You generally cannot rely on a prior 409A after a term sheet is signed or a round closes – an updated valuation incorporating the new deal terms is required.

How long is a 409A valuation valid?

A 409A valuation is valid for 12 months from the effective date, provided no material event occurs. New financing, an M&A term sheet, or a significant operational pivot immediately voids the prior valuation – a new one is required before granting more options.

What is the difference between OPM and PWERM?

The Option Pricing Method (OPM) treats equity classes as call options and is best for early-stage companies with uncertain exit timing. PWERM models specific future exit scenarios (IPO, M&A, stay private) and is best for later-stage companies with clearer exit visibility.

What happens if options are granted below FMV?

Options granted below Fair Market Value are non-compliant deferred compensation under Section 409A. This triggers immediate income tax when the option vests (not exercises), a 20% federal penalty tax, potential state penalties, and interest charges – a financial disaster for employees.

Will my 409A valuation affect my ASC 718 expense?

Yes. The 409A valuation determines the grant-date fair value of the underlying stock, which feeds directly into the Black-Scholes model used to calculate stock-based compensation expense under ASC 718. An accurate 409A ensures your financial reporting is correct and withstands audit.

ABOUT US

About IntelleK

Business Valuations For Today.... & Tomorrow

Business Valuations are an "opinion of value" so finding the right professional valuer is key, an opinion with trust. Business Valuations need the combination of science (technology) and art (knowledge & experience).

IntelleK embraces the two worlds to deliver the most robust and efficient service to its clients, adapting to the ever changing environment of businesses and how to value them.

OUR PURPOSE

Transferring Business Valuation Knowledge to Business Owners

Most business owners don't know the value of the business, let alone where the value comes from, how to influence / increase it, or where the risk exposure is, which limits its potential.

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