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The Ins & Outs of Non-Cash Compensation

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The Ins & Outs of Non-Cash Compensation

INTRODUCTION

The Ins & Outs of Non-Cash Compensation

INTRODUCTION

- Non-cash awards can be effective in hiring/retaining talent
- Many forms of non-cash compensation including required (Social Security/Medicare) and optional benefits (health insurance and retirement plans)
- Additionally, equity-based compensation can be used to help achieve company goals

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INTRODUCTION

- Important to understand the legal, tax and accounting consequences of using equity-based compensation
- Many different types of equity-based compensation, each with its own benefits and complexities
- Compliance with regulations applicable to each option is necessary to avoid challenges

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NON-CASH COMPENSATION ALTERNATIVES

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NON-CASH COMPENSATION ALTERNATIVES

- **Advantages**
  - *Companies can hire/retain employees without negative effect on corporate cash flows*
  - *Awards can help align goals of the employer and employees*

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NON-CASH COMPENSATION ALTERNATIVES

- **Underlying Concepts**
  - ***Stakeholder*** ***– any party whose well-being (economic and otherwise rises and falls with the performance and success of that organization***
  - ***Value proposition*** ***– the overall remuneration/benefits received from that individual's involvement in the organization is equal to his/her effort provided on behalf of the organization***

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NON-CASH COMPENSATION ALTERNATIVES

- **Underlying Concepts**
  - ***Tangible Non-Cash Incentives*** ***– Address tangible property awards: free trips, large employee prizes, event tickets, etc.***
  - ***Intangible Non-Cash Incentives*** ***– Items considered to be compensation: equity awards, split-life insurance policies, deferred compensation programs.***

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NON-CASH COMPENSATION ALTERNATIVES

- **Tangible Non-Cash Incentives**
  - ***Evaluability***
  - ***Separability***
  - ***Justifiability***
  - ***Social Reinforcement***
  - ***Memorability***
  - ***Promotability***

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NON-CASH COMPENSATION ALTERNATIVES

- **Intangible Non-Cash Incentives – Equity Compensation**
  - ***ESOP** – tax qualified employee benefit plan in which most or all assets are invested in stock of the employer; generally, must include at least all full-time employees of certain age and service requirements*
  - ***Stock option plan** – grants employees/participants the right to buy company stock at a specified price during a specific period once the option has vested*

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NON-CASH COMPENSATION ALTERNATIVES

- **Intangible Non-Cash Incentives – Equity Compensation**
  - ***Other forms of individual equity plans** – restricted stock plans allows employees/participants the right to acquire share (by gift or purchase) at a fair discounted value*
  - ***Phantom stock plan** – designed to move the value of shares to the employee/participant and pay a future cash or share bonus equal to the value of a certain number of shares*

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NON-CASH COMPENSATION ALTERNATIVES

- **Intangible Non-Cash Incentives – Equity Compensation**
  - ***Stock Appreciation Rights (SARs)** – right to the increase in value of a designated number of shares; usually paid in cash, but can be settled in shares*
  - ***Stock Awards** – direct shares to employee/participant*
  - ***ESPP** – employee/participant can buy stock, usually through payroll deductions over a 3-27 month offering period*

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NON-CASH COMPENSATION ALTERNATIVES

- **Typical Applications of Equity Compensation**
  - ***Private companies***
    - Companies that plan to go public or be acquired benefit from using stock options
    - Closely-held companies with owners looking to sell some of or all of their stock can use ESOPs to transfer ownership
    - Closely-held companies that will stay private but do not have a selling owner may prefer ESOPs, SARs or phantom stock

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NON-CASH COMPENSATION ALTERNATIVES

- **Typical Applications of Equity Compensation**
  - ***Public companies***
    - More flexibility when choosing stock plans
      - Already a market for the stock
      - No security issues due to previously-registered stock
      - Companies typically have larger budgets

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NON-CASH COMPENSATION ALTERNATIVES

- **Typical Applications of Equity Compensation**
  - ***Public companies***
    - Advantages/disadvantages of alternatives must be weighed
    - May want to have more than one plan to meet the strategic objectives of company and employees

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NON-CASH COMPENSATION ALTERNATIVES

- **Synthetic Equity**
  - ***Plans like phantom stock or SARS that provide employees with a payout (usually in cash) based on the company's stock value***
  - ***Relatively easy to create and maintain and usually not subject to securities laws***
  - ***Plans may be subject to ERISA rules if considered to be retirement plans***

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NON-CASH COMPENSATION ALTERNATIVES

- **Concluding Thoughts**
  - ***Many different options can be used to achieve goals***
  - ***Must comply with all applicable requirements***
  - ***Complexities of each alternative must be considered and understood to fully benefit from these plans***

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NON–CASH COMPENSATION FROM AN ACCOUNTING PERSPECTIVE

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ACCOUNTING PERSPECTIVE

- **History of Accounting for Stock-Based Compensation**
  - ***Original guidance written in 1972, updated in 1995, recommended, but did not require fair value measurement of stock options on financial statements***
  - ***Most companies elected not to record options at fair value***
  - ***As a result, options were widely used without negative impact on a company's cash flow or reported earnings***

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ACCOUNTING PERSPECTIVE

- **History of Accounting for Stock-Based Compensation**
  - ***Companies instead used intrinsic value rather than fair value, which often resulted in no compensation expense***
  - ***After accounting scandals in early 2000s, more companies began to reflect stock options at fair value***
  - ***New accounting guidance issued in 2005 (ASC 718) – required the use of a fair value methodology***

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ACCOUNTING PERSPECTIVE

- **Accounting Considerations**
  - ***Primary factors impacting how companies account for stock-based compensation center on:***
    - Calculating appropriate fair value to be recognized
    - Determining timing for recognition of expense
    - Allocating expense over relevant time period

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ACCOUNTING PERSPECTIVE

- **Requisite Service Period**
  - ***Stipulated time period during which employee must provide services to company in exchange for the award***
  - ***Used to determine when company recognizes the cost of the award in its financial statements***

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ACCOUNTING PERSPECTIVE

- **Vesting Provisions**
  - ***Govern when the units become exercisable by the employee***
  - ***Different provisions can alter the amount recorded in each of the years in the service period***
  - ***May add complexity to the accounting as the fair value of the award may be bifurcated into separate vesting layers***

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ACCOUNTING PERSPECTIVE

- **Other Considerations**
  - ***Forfeitures, based on anticipated turnover or other factors, must be estimated and incorporated into the calculation***
  - ***Probability of achieving performance measures (if required) should also be factored into the amount***
  - ***Estimates and probabilities need to be updated annually***

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ACCOUNTING PERSPECTIVE

- **Determination of Fair Value**
  - ***Based on the grant date – date on which employer and employee have mutual understanding of award terms and employee commits to the employer (or if no performance obligation, date on which award is approved may be used)***
  - ***Fair value does not consider the effects of vesting provisions or estimated forfeitures, as these are considered separately***

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ACCOUNTING PERSPECTIVE

- **Determination of Fair Value**
  - ***If fair value cannot be estimated at grant date due to complexity of terms, intrinsic value method can be used***
    - Computes difference between market price and exercise price
    - Value to be re-measured throughout the service period with the change reflected as compensation expense for that period
    - Final adjustment recorded when equity instrument is exercised

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ACCOUNTING PERSPECTIVE

- **Determination of Fair Value**
  - ***Expense amount determined under intrinsic value method can be very different from that under fair value***
  - ***Intrinsic value method exposes company to significant uncertainty and lack of control regarding expense amount, as it is tied into the market price***
  - ***Fair value method should be used whenever possible***

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ACCOUNTING PERSPECTIVE

- **Tax Considerations**
  - ***Tax-paying entities must also consider any future tax deductions available to employer when accounting for equity-based compensation***
  - ***The expected benefit to be achieved from future tax deductions must be recorded as a deferred tax benefit, which partially offsets the compensation expense recorded during the requisite service period***

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ACCOUNTING PERSPECTIVE

- **Example – Stock Options**
  - ***ABC Company approves stock option plan that may grant up to 1,000,000 options to key employees***
    - Exercise price is $0.80/share
    - Employees must remain employed for three years
    - All options vest after three years

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ACCOUNTING PERSPECTIVE

- **Example – Stock Options**
  - ***1/1/16 – Company grants 500,000 options to five managers***
    - Fair value of ABC Company common stock = $0.44; FV of options = $0.40 (determined through a valuation of the company)
    - Company estimates 90% of options will vest based on anticipated employee retention
    - Total FV of options = $200,000; $180,000 expense recognized over 3 years ($60,000 annually)

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ACCOUNTING PERSPECTIVE

- **Example – Stock Options**
  - ***ABC expects to utilize the tax deduction associated with options that are exercised***
    - Future tax benefit of current-year compensation is recorded as a reduction of annual income tax expense
    - At a tax rate of 35%, ABC Company records a $21,000 tax benefit annually for the future deduction (deferred tax asset)

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ACCOUNTING PERSPECTIVE

- **Example – Stock Options**
  - ***Stock is fully vested in three years; 100% of options exercised***
    - Fair value of ABC Company common stock = $1.40
    - Company receives $400,000 from managers for purchase of options (500,000 options at an exercise prices of $0.80/share)
    - Company records an additional $20,000 of compensation expense to adjust for difference between the estimated and actual number of options vested

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ACCOUNTING PERSPECTIVE

- **Example – Stock Options**
  - ***Total equity of $600,000 recorded by ABC Company***
    - $400,000 cash received from employees plus $200,000 expense for fair value of stock options
    - If the shares were purchased in open market, Company would have received $700,000 (at $1.40 per share)
    - Difference results from changes in marketplace, with savings in stock price realized by employees

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ACCOUNTING PERSPECTIVE

- **Example – Stock Options**
  - ***Company must also recognize tax benefit of exercised options***
    - Deduction taken by company equals gain realized by employees
    - Amount of gain is $300,000, generating tax benefit of $105,000
    - Deferred tax benefit of $63,000 already recorded during service period, so additional $42,000 to be recognized in the year that the options are exercised

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ACCOUNTING PERSPECTIVE

- **Example – Stock Options**
  - ***Accounting presumption that all vested options will be exercised***
    - An adjustment was made to reflect the difference between the estimate and the actual options vested
    - Recognition of compensation expense is not reversed if options are not exercised; paid-in capital remains on the books

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ACCOUNTING PERSPECTIVE

- **Other Common Equity-Based Compensation Arrangements**
  - ***Stock Bonus/Restricted Stock* – *based on value of stock***
    - Stock bonus plan: company issues fixed/determinable award of stock; no service or vesting period or performance requirements; recorded as compensation expense at time of the award
    - Restricted stock awards: may be subject to vesting provisions, which would be estimated for accounting purposes; may also contain other permanent restrictions, which would impact FV

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ACCOUNTING PERSPECTIVE

- **Other Common Equity-Based Compensation Arrangements**
  - ***Employee Stock Purchase Plans* – allow employees to purchase company stock, often at a discount**
    - Company must estimate FV of discount and number of shares that will be purchased
    - If plan is not compensatory, no expense needs to be recognized
      - Must not have more favorable terms than are available to others
      - Must not be exclusionary or discriminatory with respect to employees

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ACCOUNTING PERSPECTIVE

- **Other Common Equity-Based Compensation Arrangements**
  - ***Stock Appreciation Rights/Phantom Stock***
    - Cash compensation derived from change in FV of company's equity over a specified period
    - Expense related to stock appreciation rights recognized each period based on change in equity value
    - Phantom stock often contingent upon service or specified event
    - Expense recognized over period and adjusted as estimates revised

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ACCOUNTING PERSPECTIVE

- **Equity Compensation to Non-Employees**
  - ***Equity-based compensation can also be used for vendors or other service providers***
    - ASC Topic 505 – treatment of transactions with non-employees
    - Generally recognized when goods/services are received
    - Fair value can be based on value of equity instruments conveyed or value of goods/services delivered

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ACCOUNTING PERSPECTIVE

- **Concluding Thoughts**
  - ***Accounting requirements of equity-based compensation plans can be complex and varied***
    - Proper treatment requires clear communication of terms of the plan to those preparing financial statements
    - Accounting impact should be considered when establishing plans to avoid unintended financial consequences
    - Speak with a qualified advisor

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EQUITY-BASED COMPENSATION FROM A TAX PERSPECTIVE

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TAX PERSPECTIVE

- **IRC §61(a)**

  "Gross income includes income from whatever source derived"

  – ***Economic benefit from non-cash remuneration in exchange for personal services is taxable income***

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TAX PERSPECTIVE

- **Threshold measure of income**
  - ***Fair market value (for income tax purposes)***
  - ***Fair value (for accounting purposes)***

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TAX PERSPECTIVE

- **Generally, the income recognition requirements apply equally to employees and independent contractors**

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TAX PERSPECTIVE

- **IRC §83 – Three Key Elements**
  1. ***Property must be involved***
  2. ***There must have been a transfer***
  3. ***The transfer must have been made for performance of services***

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TAX PERSPECTIVE

- **Examples of Non-Cash Compensation Subject to IRC §83**
  - ***Restricted stock plans***
  - ***Nonstatutory stock options***
  - ***Nonqualified funded plans***
  - ***Stock appreciation rights***
  - ***Other tangible property***

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TAX PERSPECTIVE

- **Exceptions to IRC §83**
  - ***Incentive stock options***
  - ***Nonqualified unfunded plans***
  - ***Unsecured promises to pay***

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TAX PERSPECTIVE

- **Understanding Fair Market Value**
  - ***The price 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 arms length in an open an unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.***

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TAX PERSPECTIVE

- **Non-Cash Property Subject to Restrictions**
  - ***Special rules apply to stock/other property transferred to an employee in connection with performance of services, and that is subject to restrictions affecting its value***

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TAX PERSPECTIVE

- **Amounts are included when the property substantially vests**

IRC §83(a)

1. ***When the recipient can transfer rights to the property; or***
2. ***When the rights to the property are not subject to a "substantial risk of forfeiture"***

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TAX PERSPECTIVE

- **Restricted Property/Substantial Risk of Forfeiture**
  - ***Restricted property***
    - Property transferred to an employee as compensation that is subject to certain restrictions and restraints
    - Payments of this kind are generally not included in income or deductible by employer until it is no longer restricted

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TAX PERSPECTIVE

- **Restricted Property/Substantial Risk of Forfeiture**
  - ***Substantial risk of forfeiture***
    - Property generally subject to significant risk of forfeiture if an employee must perform substantial future services for the employer before having full enjoyment of the property

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TAX PERSPECTIVE

- **Restricted Property/Substantial Risk of Forfeiture**
  - ***Restraint on transferability***
    - Property considered as such if employee is restricted from transferring his interest in the property to anyone else other than the employer
    - If transferred restricted property is not substantially vested, payer entity cannot claim a deduction, and employee is not required to recognize income with respect to that property

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TAX PERSPECTIVE

- **Restricted Property/Substantial Risk of Forfeiture**
  - ***Property becomes substantially vested upon the earlier of:***
    - The date the substantial risk of forfeiture lapses; or
    - The date property becomes transferable
  - ***Until property becomes substantially vested, employer is treated as owner of the property***
  - ***When the property becomes substantially vested, employee recognizes income and employer claims the deduction***

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TAX PERSPECTIVE

- **Restricted Property/Substantial Risk of Forfeiture**
  - ***Property transferred in connection with the performance of services may have "non-lapse" restrictions on transferability***
    - Does not prevent employee from substantially vesting
    - Factors into the fair market value of the property for purpose of determination of income to employee or deduction to employer

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TAX PERSPECTIVE

- **Restricted Property/Substantial Risk of Forfeiture**
  - ***Non-lapse restrictions on transferability:***
    - Require employee to sell, or offer to sell, the property at a price determined by a formula
    - Continue to apply against employee or subsequent holders
    - Specific restriction can subject the property to a permanent right of first refusal

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TAX PERSPECTIVE

- **Recognition of Taxable Income Prior to Substantial Vesting**
  - ***IRC §83(b) Election***
    - Taxpayers can elect to include the excess of the property's fair market value over any amount paid for the property in income in the year the property was received (versus vested)
    - Prudent if property expected to appreciate significantly between date fair market value is included in taxable income and date when recipient is substantially vested

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TAX PERSPECTIVE

- **Recognition of Taxable Income Prior to Substantial Vesting**
  - ***IRC §83(b) Election***
    - Formal election must be made for early inclusion
    - Subsequent appreciation in value of property after initial inclusion amount does not result in additional compensation, but rather constitutes a capital gain
    - Capital gain may be taxed at preferential rates

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TAX PERSPECTIVE

- **Recognition of Taxable Income Prior to Substantial Vesting**
  - ***IRC §83(b) Election***
    - Election must be made no later than 30 days after the property is transferred
    - Currently copies to be filed both in year of election and in tax year when property is transferred
    - Additional proposed regulations eliminate second copy

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TAX PERSPECTIVE

- **Recognition of Taxable Income Prior to Substantial Vesting**
  - ***IRC §83(b) Election***
    - Statement of election must include numerous specific items
    - Copies must be given to all parties
    - Timely filing and all other applicable requirements must be met for the election to be valid

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TAX PERSPECTIVE

- **Recognition of Taxable Income Prior to Substantial Vesting**
  - ***IRC §83(b) Election***
    - Once proper election has been made, it is binding and cannot be undone without IRS consent
    - Generally, the only basis for revocation relates to a mistake of fact regarding the underlying transaction.
    - Request for revocation must be made within 60 days of the date on which the mistake became known

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TAX PERSPECTIVE

- **Recognition of Taxable Income Prior to Substantial Vesting**
  - ***IRC §83(b) Election – Tax Implications***
    - General restricted property rules do not apply and later appreciation in value of the property is not treated as compensation
    - Subsequent dividends are treated as dividend rather than compensation for services
    - Ordinary loss deduction not allowed if property is forfeited

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- **Recognition of Taxable Income Prior to Substantial Vesting**
  - ***IRC §83(b) Election – Tax Implications***
    - FMV of property is includible in gross income at the time of transfer
    - No compensation is includible in gross income when the property becomes substantially vested
    - If there is a failure to vest, no taxable gain results from sale

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TAX PERSPECTIVE

- **Recognition of Taxable Income Prior to Substantial Vesting**
  - ***IRC §83(b) Election – Tax Implications***
    - Upon forfeiture, no tax deduction or credit is available due to the loss or to previously-paid taxes
    - If property is sold/exchanged, proper basis computation is required to determine gain or loss from sale/exchange
    - If forfeited property is substantially vested, amount of loss is equal to amount paid over amount realized upon forfeit

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TAX PERSPECTIVE

- **Employer Tax Deductions for Compensation Paid with Property**
  - ***When employees are required to report compensation paid to them as cash or property as income, the employer is entitled to a corresponding deduction***
  - ***If property is restricted, IRC §83 determines amount and timing***
  - ***Key element is to match the timing of income recognition for recipient to deduction year for the company***

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TAX PERSPECTIVE

- **Employer Tax Deductions for Compensation Paid with Property**
  - ***All Events Test and Accrual of Income***
    - Method of accounting used governs when income is reported
    - All events test used under accrual method – generally not met until economic performance takes place (when services are provided to the taxpayer)

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TAX PERSPECTIVE

- **Statutory Stock Options**
  - ***Fundamentals***
    - Statutory stock options: employee generally does not realize income upon receipt
    - Nonstatutory stock options: income is realized when its fair market value is determinable

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TAX PERSPECTIVE

- **Statutory Stock Options**
  - ***What is an option?***
    - Offer made to an employee by a corporation to sell stock or equity, at a stated or determinable price, for a stated period of time, with the employee being under no obligation to buy
    - Must be evidenced in writing, including specific terms
    - Stock subject to statutory option must be capital stock

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TAX PERSPECTIVE

- **Statutory Stock Options**
  - ***Option price***
    - Consideration, of either money or property, set as the price at which the stock subject to the option may be purchased
    - Does not include amounts paid as interest in deferred payment arrangements

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TAX PERSPECTIVE

- **Statutory Stock Options**
  - ***Generally, an option is deemed granted on the date or at the time when the corporation completes corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option***
  - ***Corporate action considered to be complete when number of shares that may be purchased is fixed and determinable***

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TAX PERSPECTIVE

- **Statutory Stock Options (Incentive Stock Options) – Tax Advantages**
  - ***Statutory stock options offer significant tax advantages over nonstatutory stock options***
    - To qualify, optionee must be an employee of the granting corporation at time the option is granted, and must remain employed until within 3 months of the time he/she exercises the option

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TAX PERSPECTIVE

- **General Tax Rules for Statutory Stock & Incentive Stock Options**
  - ***Incentive stock option have regular and AMT tax implications***
    - Regular tax purposes: generally given special treatment – statutory options usually not taxed until disposition; gain is then taxed as capital gains
    - AMT tax purposes: difference between option price and FMV on date of exercise can trigger AMT in year the option is exercised; avoid by staggering income over multiple years

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TAX PERSPECTIVE

- **General Tax Rules for Statutory Stock & Incentive Stock Options**
  - ***Nonstatutory options do not receive favorable treatment***
    - Generally taxed as ordinary income at the time they are granted since they are considered to be compensation
  - ***Transfer of statutory option not considered a taxable event***
    - Employee recognizes no income as a result
    - Employer cannot take a deduction

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TAX PERSPECTIVE

- **General Tax Rules for Statutory Stock & Incentive Stock Options**
  - ***Taxation of stock options usually deferred for employee until the stock is sold***
  - ***If employee dies while holding stock with a value exceeding the option price, income will be realized***
    - If the option can be transferred to heirs, it will retain status as a statutory stock option
    - If the option is sold, will cease to be considered statutory

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TAX PERSPECTIVE

- **Inclusion of Deferred Compensation**
  - ***Nonstatutory stock option plans may qualify as a nonqualified deferred compensation plan, and IRC §409A must be considered***
    - If the plan meets the nonqualified deferred compensation requirements, there is no effect on the employee's taxes
    - If the plan does not meet the requirements, compensation is subject to additional taxes

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TAX PERSPECTIVE

- **Inclusion of Deferred Compensation**
  - ***IRC §409A timing restrictions in three main areas:***
    - Restrictions on timing and distribution
    - Restrictions against acceleration of benefits
    - Restrictions on timing of deferral elections

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TAX PERSPECTIVE

- **Inclusion of Deferred Compensation**
  - ***IRC §409A exemptions on applicability:***
    - Incentive stock options and employee stock purchase plans
    - Nonqualified stock options with an exercise price at least equal to fair market and that meet other specific requirements

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TAX PERSPECTIVE

- **Taxation of SARs/Phantom Stock Plans**
  - ***Enable company to offer incentives without diluting ownership***
    - SARs: key employee can share value increase in specified number of stock shares; paid cash when right is exercised
    - Phantom stock plans: similar to SARS, but generally offered for discrete time period; when time frame expires, paid in cash an amount equal to value growth in stock

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TAX PERSPECTIVE

- **Taxation of SARs/Phantom Stock Plans**
  - ***Payments in cash from both plans result in ordinary income tax consequences for employee and corresponding deduction for employer***
    - SARs: FICA/FUTA taxes paid when executive receives cash
    - Phantom stock plans: FICA/FUTA payments made when services are performed or employee is vested in the plan

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NON–CASH COMPENSATION FROM A VALUATION PERSPECTIVE

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VALUATION PERSPECTIVE

- **Introduction**
  - ***In recent years, many more companies, especially start-ups, frequently utilize equity-based compensation packages***
  - ***Capital structure can become complicated***
  - ***Companies must adhere to accounting and tax rules: IRC §409A and ASC 718***
  - ***Can be beneficial to enlist a valuation analyst to assist***

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VALUATION PERSPECTIVE

- **Challenges for Valuation Analysts**
  - ***Capital structure***
  - ***Future outcomes***
  - ***Stage of development***
  - ***Industry***

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VALUATION PERSPECTIVE

- **Purpose of Valuation**
  - ***Valuation prepared for a specific use may not be used for other purposes***

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VALUATION PERSPECTIVE

- **Date of Valuation**
  - ***Influences the information available for the valuation, and is the perspective from which all analysis is performed***
  - ***For equity-based compensation, is the date it is granted or as close as possible to that date***
  - ***FV determined after employees have rendered requisite services and satisfied any other conditions***
  - ***Contemplated future outcomes must be known at valuation date***

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VALUATION PERSPECTIVE

- **Standard of Value**
  - ***Fair market value (as defined by IRC §409A)***
    - *The price, expressed in terms of cash equivalents, as which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms 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.*

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VALUATION PERSPECTIVE

- **Standard of Value**
  - ***Fair value (under ASC 718)***
    - *The 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.*

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VALUATION PERSPECTIVE

- **Restrictions to Consider**
  - ***Vesting versus Non-transferability***
  - ***Forfeitability***
  - ***Service Conditions***
  - ***Performance Conditions***
  - ***Conditions affecting value of the award***

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VALUATION PERSPECTIVE

- **Control vs. Minority**
  - ***Valuation should consider company under current ownership***
  - ***Objective is to value the individual securities of the entity, rather than to value the entity itself***

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VALUATION PERSPECTIVE

- **Valuation Approaches**
  - ***AICPA Guide illustrates techniques used to determine the fair value of a company and the methods used to allocate the company's fair value to the components of its capital structure***
  - ***Approaches used to value closely-held securities:***
    - Market approach
    - Income approach
    - Asset approach

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VALUATION PERSPECTIVE

- **Valuation Approaches**
  - ***Primary considerations to determine which approach to use:***
    - The company's stage of development,
    - The company's capital structure (simple or complex), and
    - The availability of recent transactions involving the company's own securities.

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VALUATION PERSPECTIVE

- **Capital Structure**
  - ***After the fair value of the enterprise is determined, the value must be allocated to the components of the company's capital structure***

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VALUATION PERSPECTIVE

- **Capital Structure**
  - ***Simple capital structure***
    - The fair value of the common equity is equal to the fair value of the total company less the fair value of the debt held by the company
    - Note: fair value of debt can be different from its book value

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VALUATION PERSPECTIVE

- **Capital Structure**
  - ***Complex capital structure***
    - Value determinations ascribed to the various classes of equity, which requires an understanding of the economic and control rights associated with each class

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VALUATION PERSPECTIVE

- **Capital Structure**
  - ***Equity allocation methods***
    - Probability weighted expected return method (PWERM)
    - Option-pricing method (OPM)
    - Current-value method (CVM)
    - Hybrid method

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VALUATION PERSPECTIVE

- **Capital Structure**
  - ***Allocation should be performed using methods that:***
    - Reflect the going-concern status of the company,
    - Assign some value to common shares,
    - Produce results that can be replicated or approximated, and
    - Have a complexity appropriate to the security being valued

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VALUATION PERSPECTIVE

- **Equity Allocation Methods**
  - ***PWERM***
    - Explicitly considers the economic rights of each share class and computes its value under different scenarios
    - Uses estimates of different possible future outcomes available to the company to compute the value of the equity securities under these different scenarios
    - Frequently used when the company is close to an exit event

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VALUATION PERSPECTIVE

- **Equity Allocation Methods**
  - ***OPM***
    - Treats a company's securities as call options on the company's value
    - Explicitly recognizes and models the payoffs of the various share classes that resemble option-like payoffs
    - Assumes a future liquidation scenario and considers the rights and preferences of each class of securities

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VALUATION PERSPECTIVE

- **Equity Allocation Methods**
  - ***OPM – Variables Used in the Black-Scholes Model:***
    - Equity value
    - Exercise price (breakpoint)
    - Volatility
    - Time
    - Risk-free rate

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VALUATION PERSPECTIVE

- **Equity Allocation Methods**
  - ***OPM – Calculations***
    - Computed on the equity or on company's total capitalization
    - ASC 718 provides extensive guidance for companies regarding selecting OPM inputs (see pages 45-46)
    - Estimates should be reasonable, supportable and determined in a consistent manner from period-to-period

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VALUATION PERSPECTIVE

- **Equity Allocation Methods**
  - ***CVM***
    - First calculates the value of the company's equity on a control basis (assuming a sale of the company), then
    - Allocates that value to the various series of preferred stock based on liquidation preferences and/or conversion ratios
    - Any remainder is allocated to the common equity

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VALUATION PERSPECTIVE

- **Equity Allocation Methods**
  - ***CVM***
    - Primary advantage – it is easy to apply and understand
    - Primary disadvantage – the value that is allocated to the common equity does not consider the option-like nature of common stock (does not consider possible changes in value)
    - Recommended use only when liquidity event is imminent

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VALUATION PERSPECTIVE

- **Equity Allocation Methods**
  - ***Hybrid Method***
    - Takes the scenarios found in a PWERM and uses an option-pricing methodology on each scenario
    - Typically applied when significant uncertain event could materially affect the value of the company, and as a result, the range of future possible outcomes might no longer be represented by a lognormal distribution (assumed by OPM)

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VALUATION PERSPECTIVE

- **Equity Allocation Methods**
  - ***Hybrid Method***
    - Main advantage – it applies the conceptual framework of the OPM to different scenarios
    - Disadvantage – the model can become complex and require a significant number of assumptions

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VALUATION PERSPECTIVE

- **Adjustments for Control/Marketability (and Lack Thereof)**
  - ***Once the value of the preferred and common stock is determined, discounts for lack of control or marketability may be applied due to specific limitations of the stock***
  - ***In computing discounts for lack of marketability, certain factors must be considered***
  - ***May be appropriate to apply an additional discount for lack of marketability to the junior securities***

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VALUATION PERSPECTIVE

- **Practical Examples (Assumptions)**
  - ***In both examples, ABC Company has two classes of stock, representing a total of 10,000 shares outstanding:***
    - Common stock (8,000 shares)
    - Convertible preferred stock (2,000 shares)
  - ***A liquidity event is expected to occur in five years' time***

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VALUATION PERSPECTIVE

- **Practical Examples (Assumptions)**
  - ***In PWERM, four liquidity events are assumed:***
    - An IPO – 10.0% likelihood
    - A sale of the company at a price that is at the "high end" of a hypothetical range – 60.0% likelihood
    - A sale of the company that is at the "low end" of a hypothetical range – 25.0% likelihood
    - A dissolution of the company – 5.0% likelihood

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VALUATION PERSPECTIVE

- **Practical Examples (Assumptions)**
  - ***In OPM, the following assumptions are utilized:***
    - A company equity value of $5.0 million
    - A liquidity event will occur in five years' time
    - A risk-free rate of 1.46%
    - Volatility of 60.0%
    - DLOM of 20.0% will be applied to the per-share value of the common stock on a marketable basis

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Allocation Method: Probability Weighted Expected Return Method
(in $000, except for the number of shares and per-share amounts)

Security	Date Issued	Number of Shares	Value per Share	Liquidation Value	Conversion Ratio
Common Stock	01/01/15	8,000		$ -	
Series A Convertible Preferred Stock	07/31/15	2,000	$ 1.00	2,000	1:1
Total		**10,000**		**$ 2,000**	

Liquidity Event (5 years)	IPO	Sale - High	Sale - Low	Dissolution
Probability	10.0%	60.0%	25.0%	5.0%
Equity Value at Liquidity Event	$ 20,000	$ 15,000	$ 10,000	$ 4,000
Less: Series A Convertible Preferred Stock Preference	$ -	$ -	$ -	$ 2,000
Residual Equity Value	$ 20,000	$ 15,000	$ 10,000	$ 2,000
Allocation of Equity Value				
Series A Convertible Preferred Stock	$ 4,000	$ 3,000	$ 2,000	$ 2,000
Common Stock	16,000	12,000	8,000	-
Total	**$ 20,000**	**$ 15,000**	**$ 10,000**	**$ 2,000**

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Allocation Method: Probability Weighted Expected Return Method
(in $000, except for the number of shares and per-share amounts)

Security	Date Issued	Number of Shares	Value per Share	Liquidation Value	Conversion Ratio
Weighted Equity Value: Series A Convertible Preferred Stock					
Probability Weighted Equity Value		$ 400	$ 1,800	$ 500	$ 100
Total Weighted Equity Value					2,800
Present Value @	20.0%				1,125
Number of Shares					2,000
Fair Value: Series A Convertible Preferred Stock					**$ 0.56**
Weighted Equity Value: Common Stock					
Probability Weighted Equity Value		$ 1,600	$ 7,200	$ 2,000	$ -
Total Weighted Equity Value					10,800
Present Value @	20.0%				4,340
Number of Shares					8,000
Fair Value: Common Stock					**$ 0.54**

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Allocation Method: Option Pricing Method
(in $000, except for the number of shares and per-share amounts)

Security	Date Issued	Number of Shares	Value per Share	Liquidation Value	Conversion Ratio
Common Stock	01/01/15	8,000		$ -	
Series A Convertible Preferred Stock	07/31/15	2,000	$ 1.00	2,000	1:1
Total		**10,000**		**$ 2,000**	

Breakpoint Analysis	Number of Shares	Breakpoint	1	2	3
Security			**$0 - $2,000**	**$2,000 - $5,000**	**> $5,000**
Series A Convertible Preferred Stock	2,000		100.0%	0.0%	20.0%
Common Stock	8,000		0.0%	100.0%	80.0%
Total	**10,000**		**100.0%**	**100.0%**	**100.0%**

Black-Scholes Model Assumptions	
Company Equity Value	$ 5,000
Time to Liquidity Event (years)	5.0
Risk-Free Rate	1.46%
Volatility	60.0%

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Allocation Method: Option Pricing Method
(in $000, except for the number of shares and per-share amounts)

		Breakpoint	1	2	3
Security	**Value per Share**	**Allocated Value**	**$0 - $2,000**	**$2,000 - $5,000**	**> $5,000**
Series A Convertible Preferred Stock	$ 0.75	$ 1,500	$ 1,000	$ -	$ 500
Common Stock	0.44	3,500	-	1,500	2,000
Total		$ 5,000	$ 1,000	$ 1,500	$ 2,500

Security	Value per Share (marketable)	Less: DLOM	Value per Share (non-marketable)
Series A Convertible Preferred Stock	$ 0.75		**$ 0.75**
Common Stock	$ 0.44	20.0%	**$ 0.35**

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VALUATION PERSPECTIVE

- **Conclusion**
  - *Complex valuation requires qualified professionals that understand all relevant factors and circumstances*
  - *Legal counsel can consult with a valuation analyst before implementing a plan to fully understand the effects it may have on the company*

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CONCLUSION AND PRACTICAL CONSIDERATIONS

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CONCLUSION AND PRACTICAL CONSIDERATIONS

- **Many benefits of non-cash awards**
  - ***Enhance employee retention***
  - ***Align employee goals to those of company***
  - ***Fill compensation gaps for critical employees***
  - ***Allow for differentiation in employment offers to improve recruiting success***

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CONCLUSION AND PRACTICAL CONSIDERATIONS

- **Concerns regarding issuing equity compensation:**
  - ***Dilution of ownership/control***
  - ***Potential transfer to non-affiliated third parties***
  - ***Valuation of non-publicly-traded security***
  - ***Funding companies repurchase***

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CONCLUSION AND PRACTICAL CONSIDERATIONS

- **Remedies for concerns:**
  - ***Issue nonvoting equity interests or SARs to be settled in cash***
  - ***Establish transfer restrictions forcing sale back to company upon triggering events***
  - ***Valuations can determine fair market value as needed***
  - ***Numerous options available to fund repurchase***

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CONCLUSION AND PRACTICAL CONSIDERATIONS

- **Non-cash, equity-based compensation can be utilized as a practical means to attaining company's strategic goals**
  - ***Plan document must be carefully crafted and include all pertinent details***
  - ***Additionally, rights granted by other corporate documents must be considered***
  - ***GYF professionals can assist legal counsel and their clients***

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THANK YOU!

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