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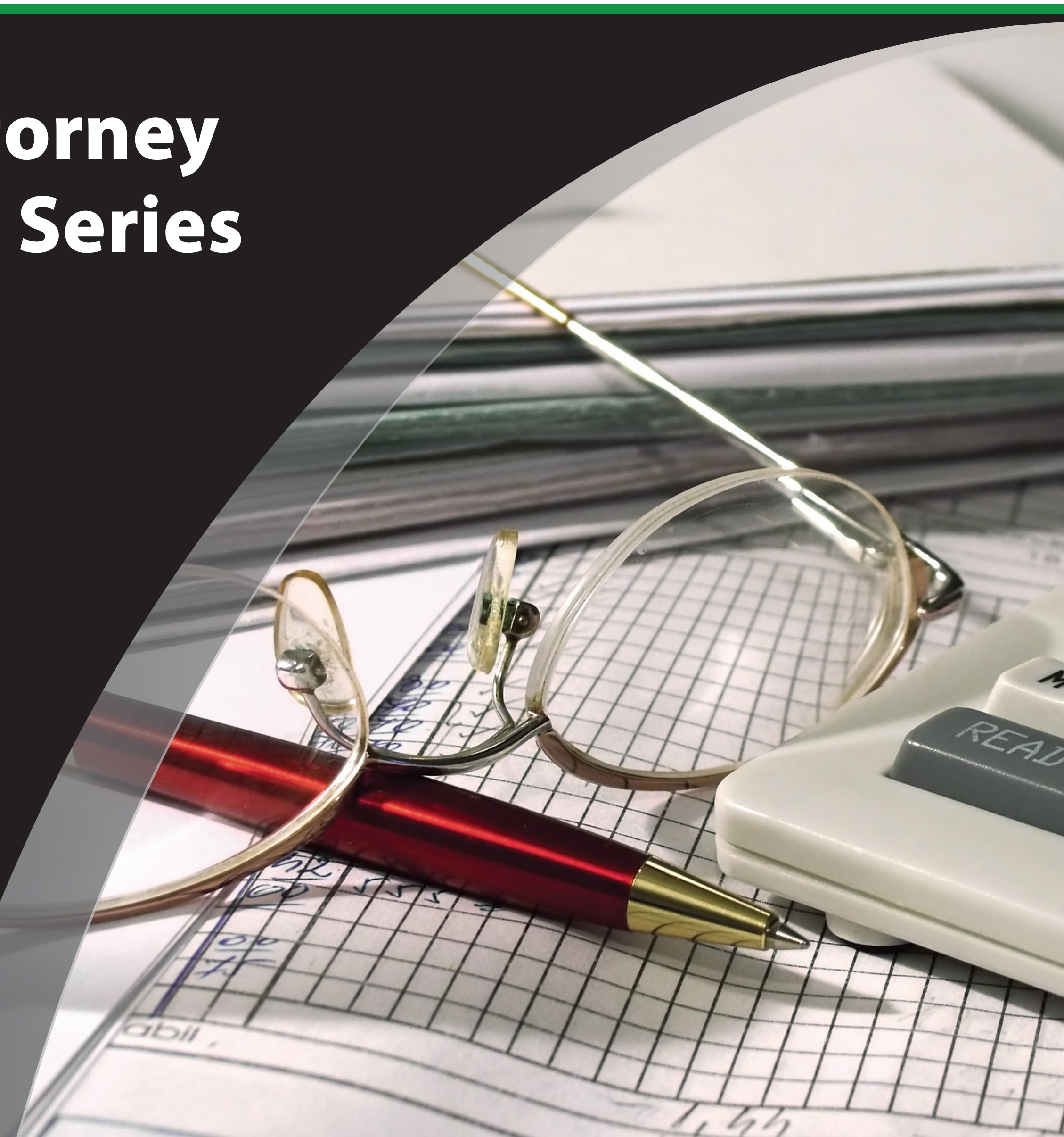

The Ins and Outs of Non-Cash Compensation

February 4, 2016

GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

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Grossman Yanak & Ford LLP

Headquartered in Pittsburgh, Grossman Yanak & Ford LLP is a regional certified public accounting and consulting firm that provides assurance and advisory, tax planning and compliance, business valuation, ERP solutions and consulting services. Led by six partners, the 25-year-old firm employs approximately 55 personnel who serve corporate and not-for-profit entities.

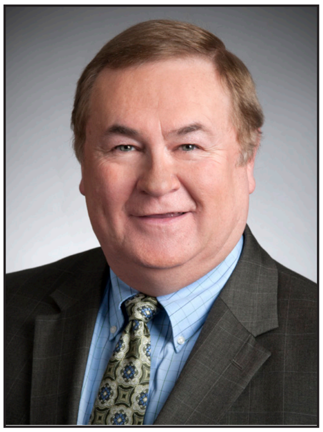
Our firm was founded on the idea that the key to successful, proactive business assistance is a commitment to a high level of service. The partners at Grossman Yanak & Ford LLP believe that quality service is driven by considerable involvement of seasoned professionals on a continuing basis. Today's complex and dynamic business environment requires that each client receive the services of a skilled professional with a broad range of experience and knowledge who can be called upon to provide efficient, effective assistance.

Grossman Yanak & Ford LLP combines a diversity of technical skills with extensive "hands-on" experience to address varied and complex issues for clients on a daily basis. We pride ourselves on bringing value-added resolution to these issues in a progressive and innovative manner. Our ability to produce contemporary, creative solutions is rooted in a very basic and ageless business premise – quality service drives quality results. Our focus on the business basics of quality technical service, responsiveness and reasonable pricing has enabled the firm to develop a portfolio of corporate clients, as well as sophisticated individuals and nonprofit enterprises.

Our professionals understand the importance of quality and commitment. Currently, the majority of the professional staff in our Assurance & Advisory Services and Tax Services Groups hold the Certified Public Accountant designation or have passed the examination and need to complete the time requirements for certification. Each of our peer reviews has resulted in the highest-level report possible, attesting to the very high quality of our firm's quality control function. The collective effort of our professionals has resulted in our firm earning an exemplary reputation in the business community.

Grossman Yanak & Ford LLP…Quality You Deserve!

Robert J. Grossman, CPA/ABV, ASA, CVA, CBA



Bob heads our firm's Tax and Business Valuation Groups. He has over 35 years of experience in tax and valuation matters that affect businesses, both public and private, as well as the stakeholders and owners of these businesses. The breadth of his involvement encompasses the development and implementation of innovative business and financial strategies designed to minimize taxation and maximize owner wealth. As his career has progressed, Bob has risen to a level of national prominence in the business valuation arena.

His expertise in business valuation is well known, and Bob is a frequent speaker, regionally and nationally, on tax and valuation matters. Bob is a course developer and national instructor for both the American Institute of Certified Public Accountants (AICPA) and the National Association of Certified Valuators and Analysts (NACVA). He has served as an adjunct professor for Duquesne University and Saint Vincent College. He has also written articles for several area business publications and professional trade journals.

After graduating from Saint Vincent College in 1979 with Highest Honors in Accounting, Bob earned a Masters of Science degree in Taxation with Honors from Robert Morris University. He is a CPA in Pennsylvania and Ohio and is accredited in Business Valuation by the AICPA. Bob also carries the well-recognized credentials of Accredited Senior Appraiser, Certified Valuation Analyst and Certified Business Appraiser.

A member of the American and Pennsylvania Institutes of Certified Public Accountants (PICPA), Bob has previously chaired the PICPA Pittsburgh Committee on Taxation. He has also served as Chair of the Executive Advisory Board of NACVA, its highest Board; as well as Chair of NACVA's Professional Standards Committee and its Education Board.

Bob received NACVA's "Thomas R. Porter Lifetime Achievement Award" for 2013. The award is presented annually to one of the organization's 6,500 members, who has demonstrated exemplary character, leadership and professional achievements to NACVA and the business valuation profession, over an extended period.

Bob is a member of the Allegheny Tax Society, the Estate Planning Council of Pittsburgh and the American Society of Appraisers. He has held numerous offices in various not-for-profit organizations. Bob received the PICPA Distinguished Public Service Award and a Distinguished Alumnus Award from Saint Vincent College.

Bob and his wife, Susie, live in Westmoreland County. They have two grown children.

Melissa A. Bizyak, CPA/ABV/CFF, CVA

Melissa, a partner in the firm's Business Valuation & Litigation Support Services Group, has practiced in public accounting for more than 21 years. She has significant experience in business valuation and tax-related issues for privately-held concerns and their owners.

Her business valuation experience is very diverse, including valuations of companies in the manufacturing, oil and gas and technology industries. These valuations have been performed for various purposes such as financial reporting, equitable distributions, buy/sell transactions, dissenting shareholder disputes, Employee Stock Ownership Plans (ESOPs), value enhancement and gift and estate tax purposes. Melissa also provides litigation support services including expert witness testimony.

After graduating from the University of Pittsburgh in 1994 with a B.S. in Business/Accounting, Melissa spent two years with a local accounting firm in Pittsburgh. She joined Grossman Yanak & Ford LLP in 1997.

Melissa is a certified public accountant. She is accredited in business valuation and certified in financial forensics by the American Institute of Certified Public Accountants (AICPA). She has also earned the AICPA Certificate of Achievement in business valuation. Additionally, Melissa carries the credentials of Certified Valuation Analyst.

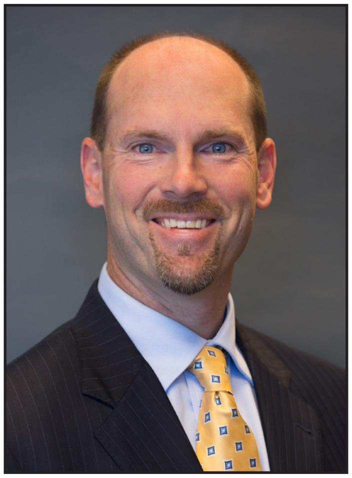
Her professional affiliations include the AICPA, the Pennsylvania Institute of Certified Public Accountants (PICPA) and the Estate Planning Council of Pittsburgh. She is a member and serves as the Chair of the Executive Advisory Board of the National Association of Certified Valuators and Analysts (NACVA).

Melissa has written business valuation course-related materials and serves as a national instructor for NACVA. She has also authored articles appearing in professional publications.

Melissa is a graduate of Leadership Pittsburgh, Inc.'s Leadership Development Initiative. She serves on the Board of Directors of the Children's Museum of Pittsburgh and is a member of the Executive Leadership Team for the American Heart Association's "Go Red for Women" initiative. Melissa is also a mentor for women business owners through Chatham University's MyBoard program.

Melissa resides in the South Hills of Pittsburgh with her husband and their two sons.

Steven M. Heere, CPA



Steve, a partner in the firm's Audit & Assurance Services Group, has practiced in the public accounting field for 20 years. He has extensive experience in audit and accounting for both privately-held companies and not-for-profit entities. Steve serves a wide array of industries, including manufacturing, construction, service businesses and technology development.

Steve brings experience in dealing with acquisitions and divestitures, due diligence procedures, contract accounting, and financial statement analysis. He provides insight tailored to meet the needs of individual circumstances involving family-owned businesses, private equity investments or international corporations. Steve focuses on delivering services in a responsive and value-added manner.

He also specializes in providing accounting and auditing services to not-for-profit organizations, including the enhanced auditing and reporting requirements for federal, state and local funding. He has provided guidance on revenue recognition, fund accounting, cost allocation, fund-raising, cost controls and other issues pertinent to not-for-profit entities.

After graduating from Grove City College with Highest Honors in Accounting, Steve joined Grossman Yanak & Ford LLP in 1995. As a CPA in Pennsylvania, he is a member of the Pennsylvania and American Institutes of Certified Public Accountants (PICPA/AICPA). He successfully completed the PICPA Next Generation Leaders program, an extensive training course for future firm leaders.

Steve's service to the community includes serving as treasurer for Shoulder to Shoulder Pittsburgh-San Jose, Inc., a not-for-profit organization that provides medical and nutritional support to a rural area of Honduras, as well as serving as the president of a local preschool. He is also very involved as an elder in his church and as a coach with the Shaler Soccer Club.

He resides in Shaler Township with his wife, Heather, and their children, Noah and Laura.

Table of Contents

The Ins and Outs of Non-Cash Compensation

I. Introduction

In an environment of relatively low unemployment and competition for quality talent, retention of human capital is paramount to both economic and business success. The current limitations on identifying quality candidates for any key position, the daunting nature and unknown outcomes of a continual recruiting process and the ongoing absorption of training and learning costs (and inefficiency throughout that process) combine to make key employee retention a critical element of every company's human resource planning.

More and more often, an important element in this human resource planning is the use and integration of non-cash rewards and remuneration into an individual's overall compensation package. There is no question that cash payments will stand front and center in any compensation package. However, in the right circumstances and in the appropriate combinations, non-cash rewards and remuneration can often prove to be a more effective motivator than simply paying a cash salary. The fundamental assumption that cash, alone, can accomplish the goals of employee retention for the mid- to long-term employee is flawed. The issue of a solely-cash compensation structure is rooted in economic precepts that are often not deemed important to those candidates available in the employment force. The salient question is always, "What is the candidate expecting from the employment opportunity, and is the answer to that question simply cash?"

The sheer competitive nature of recruiting quality individuals requires differentiation of employment offers to distinguish one employer from the next. There are numerous studies and commentaries noting the differences between one generation of employees (i.e., Boomers) and other generations (i.e., Gen X and Millennials). It goes without saying that these differences are very real and must be respected in the human resources function of any organization to ensure that the needs and goals of all candidates are met in position structure and compensation structure. The greater care given to this process, the better the organization's human resources effort and recruiting and retention outcomes will be. In many ways, non-cash compensation structures can answer these challenges.

Non-cash compensation can take many forms. Everything from free coffee to a company picnic, discounted parking, healthcare and equity compensation can be characterized under non-cash compensation. Most frequently, though, it refers to the value of more-traditional benefits, which can include the mandatory benefits such as Social Security and Medicare, unemployment and worker's compensation. These are the items that 95% of employers in the United States must provide under federal and state employment laws. However, the term can also include voluntary benefits such as health, dental and vision insurance. And, very often, non-cash compensation's most common usage includes some type of retirement plan, as well.

The Ins and Outs of Non-Cash Compensation

One reason employees place a high value on the non-cash compensation parts of a total compensation package is because they can greatly reduce their household expenses. For example, getting an employer's help with health insurance premiums can save a family many hundreds of dollars a month, not to mention savings from the better medical coverage likely provided by a group plan.

A step beyond these types of non-cash compensation, and the topic of today's presentation, are the various types of equity-based compensation. Ever more important for higher-level executives and start-up companies, equity-based compensation allows employees to share in the upside of the organization's business endeavors. Moreover, the side benefit of having employee efforts vested in company performance provides a different level of employee involvement not easily accomplished by other means.

Grants of equity compensation provide an excellent opportunity for employees to earn additional income beyond salary and to acquire an ownership interest in the company. Equity compensation can be particularly useful to a start-up company, which may not have the cash necessary to adequately attract, retain and motivate employees with market-rate salaries. In certain industries, it is standard practice for a start-up company to include equity as a part of every employee's compensation package.

To make the best use of an equity compensation program, a start-up company must understand the legal implications, tax consequences and accounting treatment of granting each type of equity award. A start-up company could face personnel issues and public relations problems if, as a result of not understanding the tax consequences of granting a certain type of award, the company causes its employees tax problems that may have been avoided by using a different type of equity.

The breadth of equity-based compensation can be far reaching, limited only by the creativity of the legal, accounting and tax teams structuring the equity-based compensation plan. Examples of the different types of equity-based compensation plans are listed below with additional detail on the chart on the following page.

- Incentive Stock Options
- Phantom Stock/Stock Appreciation Rights
- Restricted Stock
- Preferred Stock
- Nonqualified Stock Options
- Profits Interests
- Common Stock
- Warrants

Each type of equity-based award is subject to certain complexities and technical requirements that employers must carefully consider prior to adoption. Such consideration will allow for the accomplishment of the strategic advantages offered by each alternative and will serve to ensure that the employers' goals and objectives are met.

The Ins and Outs of Non-Cash Compensation

TYPE	DESCRIPTION	BENEFITS
Stock Options	Grants employees the right to purchase equity (stock) in the company at a predetermined exercise price during a set time period in the future.	Provides an incentive for employees because options allow them to benefit from the increase in value of the company. Also provides some liquidity to the company upon exercise.
Restricted Stock Awards	A grant of stock, which may be subject to forfeiture if certain future conditions are not met (e.g., continued employment for a period of time or achievement of certain performance goals such as revenue or net income).	Provides an incentive to employees, and helps to retain employees if accompanied by a forfeiture provision.
Equity Bonuses	Performance bonuses paid in the form of equity instead of cash.	Provides an incentive to employees to meet performance goals while minimizing cash outlays by the company.
Stock Purchase Plans	Permits employees to purchase equity in the company at a discount to fair market value.	Provides an incentive to employees by allowing them to participate in the growth of the company, while providing the company with some liquidity.
Stock Appreciation Rights (SARs)	Entitles employees to receive cash or stock in an amount equal to the excess of the fair value of the company's equity on the date of exercise over the exercise price, which is typically equal to the fair value of the company's equity on the date of grant.	Provides employees with the same financial gain as would a comparable stock option, without requiring a cash outlay upon exercise. Thus, provides an incentive to employees and serves to retain them. If settled in cash, SARs will not give up any control of the company.
Phantom Stock Units	Entitles employees to receive cash or stock in an amount equal to the value of an equivalent number of shares of stock, or the appreciation in value of an equivalent number of shares of stock since the date that the units were awarded, upon the occurrence of one or more predetermined events (e.g., a change in control of the company, retirement at or after age 65, etc.).	Similar to SARs, but realization of value is tied to the occurrence of an event rather than the employee's unilateral election.

The long-term incentives described above can be replicated to varying degrees if the company is an LLC or a partnership rather than a corporation.

Once a Company selects the most appropriate type(s) of equity-based compensations plans to accomplish its objectives, it will begin the complex processes of document preparation, accounting presentation and tax compliance. The process of document preparation falls to legal counsel, though we often work closely with legal representatives to ensure that the economics envisioned by all parties will be accomplished via the final documents and plan structure. The accounting presentation and tax compliance processes are regulated by the plan documents, governing accounting literature and tax law of course, but the key elements of fulfilling employer and employee responsibilities in these areas are based on valuation matters. Each of these elements will be discussed later in these materials. Valuation, especially in the context of these processes, is perhaps the most critical and complex element relating to the adoption of one of these plans.

The Ins and Outs of Non-Cash Compensation

Today's program will turn to the accounting, tax and valuation matters that challenge practitioners and clients alike in assessing the propriety of such non-cash compensation vehicles in conjunction with organization goals and objectives in recruiting and retaining talent to facilitate future success.

The ability to convey all of the important elements in this decision-making process is impossible in the limited timeframe of this presentation. However, it is the presenters' hope and objective to introduce and/or refamiliarize today's participants to a number of those key items that should be considered in conjunction with the adoption of equity-based non-cash compensation programs. We will address the topics in the following chapters:

- *Chapter II* – Non-Cash Compensation Alternatives
- *Chapter III* – Equity-Based Compensation from an Accounting Perspective
- *Chapter IV* – Equity-Based Compensation from a Tax Perspective
- *Chapter V* – Equity-Based Compensation from a Valuation Perspective
- *Chapter VI* – Conclusion and Practical Considerations

The authors will be available after the presentation to answer any questions you may have, or please do not hesitate to contact them at a later date. Their phone numbers and email addresses are listed below.

Bob Grossman	Melissa Bizyak	Steve Heere
412-338-9304	412-338-9313	412-338-9307
grossman@gyf.com	bizyak@gyf.com	heere@gyf.com

We appreciate the support you have shown our Firm in the past and we look forward to working with each of you in the future.

The Ins and Outs of Non-Cash Compensation

II. Non-Cash Compensation Alternatives

The primary advantages of using non-cash compensation can be significant. The first of these is economic, confirming what the simple terminology already tells us – that is, these amounts may be paid under a variety of circumstances without using organization cash flows. Thus, non-cash compensation gives an employer the ability to provide an economic reward to an employee while preserving corporate cash flows for investment on other fronts.

A second significant advantage resulting from the utilization of non-cash compensation is the capability to use these rewards as a means of aligning the goals and objectives of the organization with the emotional profiles and priorities of its workforce. In the current paradigm of employment and human resources strategy, it is important that organizations take care of their skilled employees by matching the overall compensation and rewards programs with what people are truly seeking in a position – challenging and rewarding work, meaningful relationships within the organization, acknowledgement and confirmation of their personal contributions to the overall success of the organization and, finally, freedom and flexibility to strike an appropriate "work/life balance."

Underlying Concepts

In order to understand the intricacies of non-cash compensation, it is important to first know about the basics, which are briefly described in this section.

In earlier presentations presented by this Firm, we have spoken of employees as "stakeholders" in their employers' organizations and companies. By simple definition, a stakeholder in any organization is any party whose well-being (economic and otherwise) rises and falls with the performance and success of that organization.

Another important concept to understand is "value proposition." The value proposition, with respect to employee stakeholders, is simply that the overall economic remuneration and benefits received from that individual's involvement in the organization is equal to the effort provided on his or her behalf to that organization. When this balance is out of sync or the value proposition is not met, it causes employee disgruntlement, employer dissatisfaction or a combination of both.

A failure to recognize this situation and remedy the matter will likely result in a separation. In these circumstances, keen perception on both the part of the employee and employer is critical. Understanding these potential conflicts and how best to address and manage them is an important element of human resources planning and strategy development.

The Ins and Outs of Non-Cash Compensation

Finally, non-cash compensation can be bifurcated into "tangible non-cash incentives" and "intangible non-cash incentives." The former is intended to address tangible property awards, such as free trips, large employee prizes and event tickets. In providing these types of incentives, the employer does not save cash flow. Rather, cash compensation is simply redirected to these types of awards.

The latter is comprised generally of those items more commonly thought to be compensation, including equity awards, split-life insurance policies and deferred compensation programs. While the primary focus of today's programs will be on the intangible non-cash incentives, the provision of tangible non-cash awards deserves brief mention primarily due to employee/participant perceptions regarding these types of compensation.

Tangible Non-Cash Incentives

In a comprehensive study of these matters, titled, *The Benefits of Tangible Non-Monetary Incentives*,[1] the author presents four key reasons for using non-cash awards in employee incentive or recognition programs. This separation offers an interesting perspective into payor and payee perceptions regarding the use of non-cash awards. A brief overview of these items follows:

- ***Evaluability*** – When properly presented, non-cash awards can often ignite employee imagination in a manner that enhances their perceived value. The employee participant's reaction (and perception) to the award can substitute for its actual value.

- ***Separability*** – Non-cash awards deliver more recognition because they do not get mixed with cash compensation. Cash enhancement programs, such as bonuses, invariably turn the extra reward (for past performance) into expected compensation (for future performance). Cash creates an expectation and an environment of entitlement – employers can provide such bonuses, but they are not easily rescinded. On the other hand, non-cash benefits are often able to be turned on and off without similar entitlement issues.

- ***Justifiability*** – Employee participants receive a psychological boost of satisfaction from non-cash awards because the awards carry little current liquidity and, as such, a lack of guilt associated with spending them. Studies confirm that substantial portions of cash bonuses are spent more recklessly than non-cash awards where greater consideration, and usually, time, is required before the benefits can be liquidated.

- ***Social Reinforcement*** – Employee participants often feel free to talk about non-cash rewards in a way that would be inappropriate for cash compensation. Generally, it is deemed socially unacceptable to reveal or discuss cash bonuses or commissions. However, it is much more acceptable to talk about an incentive trip to Maui. As such, non-cash prizes can provide a tangible symbol of achievement.

[1] *The Benefits of Tangible Non-Monetary Incentives,* Scott Jeffrey, January 20, 2010, http://theirf.org/research/the-benefits-of-tangible-non-monetary-incentives/205/

The Ins and Outs of Non-Cash Compensation

Mike May, President of Spear One, a full-service incentive marketing company out of the Dallas area, notes in a Linked-In post that two additional elements of non-cash compensation should be considered in assessing the employee/participant perception. These two items include:

- ***Memorability*** – Numerous surveys confirm that merchandise, travel rewards and other non-cash remuneration are remembered far longer than cash remuneration, with an attached longer-lasting boost in employee performance. These awards often provide a lasting reminder of success and reinforce a positive association with the sponsoring employer company.
- ***Promotability*** – Straight cash compensation is hard to promote from the point of view of the employer – unless that employer continues to increase the amount. Non-cash awards, on the other hand, present tangible alternatives that can whet the appetites of employees/participants. If they can see the reward, they will tend to want the reward, and then consider how best to improve their performance to earn it.

Intangible Non-Cash Incentives – Equity Compensation

The principal mechanism by which to supplement cash compensation for higher levels of management personnel has been through the provision of equity awards and nonqualified deferred compensation. Again, focusing today on equity-based compensation, these awards can be fashioned in any number of ways, but the overall thrust of such strategies is to provide employees/participants with a means by which their personal efforts are directly aligned with the interests of the company granting the equity awards and the other equity holders within that organization. The primary plan alternatives allowing for employee/participant receipt of equity in the form of compensation include:

- ***Employee Stock Ownership Plan (ESOP)*** – This is a type of tax-qualified employee benefit plan in which most or all of the assets are invested in stock of the employer. As a tax-qualified plan (like profit sharing and 401(k) plans, which are governed by many of the same laws), an ESOP generally must include at least all full-time employees meeting certain age and service requirements. Employees do not actually buy shares in an ESOP. Instead, the company contributes its own shares to the plan, contributes cash to buy its own stock (often from an existing owner) or, most commonly, has the plan borrow money to buy stock, with the company repaying the loan. All of these uses have significant tax benefits for the company, the employees and the sellers. Employees gradually vest in their accounts and receive their benefits when they leave the company (although there may be distributions prior to that time). Close to 13 million employees in over 7,000 companies (mostly closely-held), participate in ESOPs

  Please note that ESOPs are not the primary topic of today's presentation and are addressed in depth in other CLE presentations previously presented by GYF . Materials can be found at: http://gyf.com/resources/documents/

The Ins and Outs of Non-Cash Compensation

- ***Stock option plan*** – This type of plan grants employees/participants the right to buy company stock at a specified price during a specified period of time once the option has vested. As an example, assume an employee receives an option on 100 shares of XYZ Company at $10 per share. If the stock price then rises to $20, the employee can "exercise" the option and buy those 100 shares at $10 each, then sell them on the market for $20 each, and pocket the difference. If the stock price never rises above the option price, the employee will simply not exercise the option.

  Stock options can be given to as many or as few employees as an employer may wish. As will be addressed later in these materials, stock options may be qualified or nonqualified and may be issued by both privately-held and public companies. According to National Center for Employee Ownership, about nine million employees, working in thousands of companies, both public and private, presently hold stock options.

- ***Other forms of individual equity plans*** – Restricted stock plans gives employees/participants the right to acquire shares, by gift or purchase, at a fair discounted value. These employees/participants can only take possession of the shares once certain requirements and restrictions (usually including vesting) are met.

- ***Phantom stock plan*** – This is not exactly an equity plan as capital equity interests are never issued to employees/participants. Instead, these plans are designed to move the value of shares to the employees/participants and pay a future cash or share bonus equal to the value of a certain number of shares. When phantom stock awards are settled in the form of stock, they are generally called restricted stock units.

- ***Stock appreciation rights (SARs)*** – This option provides the right to the increase in the value of a designated number of shares. The amount is usually paid in cash, but occasionally settled in shares (this is called a "stock-settled SAR").

- ***Stock awards*** – These are direct grants of equity shares to employees/participants. In some cases, these shares are granted only if certain performance conditions (corporate, group or individual) are met. These awards are usually called performance shares.

- ***An employee stock purchase plan (ESPP)*** – Somewhat similar to a stock option plan, these plans give employees/participants the opportunity to buy stock, usually through payroll deductions over a 3- to 27-month "offering period." The price is usually discounted up to 15% from the market price on any purchase date. Frequently, employees can choose to buy stock at a discount from the lower of the price at either the beginning or the end of the ESPP offering period, which can increase the discount further.

  As with a stock option, after acquiring the stock the employee can sell it for a quick profit or hold onto it until a later date. Unlike stock options, the discounted price built into most ESPPs means that employees can often profit even if the stock price has gone down since the date of grant.

The Ins and Outs of Non-Cash Compensation

Companies usually set up ESPPs as tax-qualified "IRC Section 423" plans, which means that almost all full-time employees with two or more years of service must be allowed to participate (although in practice, many choose not to). Many millions of employees, almost always in public companies, participate in ESPPs.

Generally, any type of equity compensation award is tied to employee retention. Thus, the vesting schedule to hold an unfettered right to the equity interest commonly extends into the future several years to ensure that the award program is working to hold employees at the granting company.

Typical Applications of Equity-Based Compensation

Private Companies

- ***Companies that plan to go public or be acquired (high-tech startups, etc.)*** – Despite all the stock market and accounting rule changes that have occurred over the last decade, options are still the currency of choice when it comes to attracting and retaining good employees; oftentimes, quality high-tech workers will not accept a job without stock options. As a company prepares to go public, it is common to put a stock purchase plan in place as well. There is also a growing interest in combining stock appreciation rights and restricted stock programs.

- ***Closely-held companies with owners looking to sell some or all of their stock*** – An ESOP is often the best available choice. In most cases, the ESOP will borrow money to buy out the shares, but the company may also put in cash for several years in a gradual sale. Companies can use pre-tax dollars to buy an owner out – there is no other way to do this than an ESOP. If the company is a C corporation (rather than S), the owner, if certain conditions are met, is able to avoid paying any taxes on the sale proceeds, provided they are rolled over into stocks and bonds of U.S. operating companies. Stock options would not work.

- ***Traditional closely-held companies that will stay private but do not have a selling owner*** – If the company is not going to experience a liquidity event (going public or being acquired), then it has multiple choices.
  - An ESOP provides, by far, the most extensive array of tax benefits to employees and the company. However, an ESOP requires that the allocation of stock be made based on relative compensation or a more-level formula, subject to vesting and service requirements to enter the plan.
  - Stock appreciation rights or phantom stock are usually the best choice if a company wants to provide rewards to key and critical employees based on merit or some other discretionary basis. With stock options or a stock purchase plan, a company would need to create a market for the stock, which could create costly and cumbersome securities law issues.

The Ins and Outs of Non-Cash Compensation

Public Companies

In many ways, public companies have more flexibility when choosing a stock plan, for a number of reasons: (1) there is a market for the stock, meaning that the company does not have to create a market to acquire the shares from its employees/participants; (2) there are no securities issues since the stock is already registered; and (3) these companies typically have larger budgets than private companies, some of which, for example, balk at paying the hefty sums associated with setting up an ESOP or other equity-based compensation arrangement.

Thus, for public companies, the selection process has less to do with eliminating the plans that simply do not work well and more to do with weighing the advantages and disadvantages of each alternative.

Stock options, restricted stock plans, stock appreciation rights and phantom stock (and to a lesser extent stock purchase plans) are especially useful when a company is hiring the kinds of employees who expect these types of non-cash compensation as a condition of employment. In addition, having employees/participants buy stock through options and purchase plans can be a source of cash inflow for the company.

Using a §401(k) plan for employer stock in a public company is more controversial. In the wake of accounting scandals at Enron and other companies, dozens of lawsuits were filed against employers and plan fiduciaries for not removing employer stock as an investment option in a §401(k) plan and/or continuing to contribute company stock as a match. The same process occurred again in the wake of the stock market crash in the great recession of 2008 and 2009. Employees started to move more assets out of employer stock (down from 19% at the start of the decade to about 10% at the end), and companies became more cautious about overloading company stock in those plans. For many companies, this course is the prudent one.

In many cases, a company may want to have at least two kinds of plans: for example a broad-based stock option plan plus an ESOP, or an executive option plan plus a broad-based §423 purchase plan, etc. Ultimately, those plans selected will depend upon the desires and strategic needs of the company and its employees.

Synthetic Equity

"Synthetic equity" refers to plans such as phantom stock or stock appreciation rights that provide employees with a payout, usually in cash, based on the increase in the company's stock value. Employees may receive stock instead of cash; in the case of phantom stock settled in shares, this, too, is usually referred to as a restricted stock unit plan.

Synthetic equity plans are relatively easy to create and maintain, and they are generally not subject to securities laws. The underlying stock still must be valued in some reasonable way (not just a guess by the board

The Ins and Outs of Non-Cash Compensation

of directors or a simple formula) and grants are treated as compensation for accounting purposes. If the plans are designed to pay out at retirement or some date well into the future, they could be considered retirement plans and, thus, be subject to the complex rules of the Employee Retirement Income Security Act (ERISA) if not limited to a small number of employees. Plans with typical payouts of three to five years are not a problem.

Concluding Thoughts

As noted earlier, the types and structures of equity-based compensation plans can be as broad as the creativity of the planners. However, within the constructs of that creativity, it is necessary that any plan alternative be developed in a way that complies with the accounting, tax and valuation rules and requirements. Additionally, the adopting organization must fully comprehend the reach of these various technical issues.

The use of equity-based compensation is not for the faint of heart, and the complexities of the various alternatives must be fully considered and understood to take full advantage of the benefits of using such employment arrangements. The balance of today's presentation will focus on a number of these many complexities.

The Ins and Outs of Non-Cash Compensation

III. Equity-Based Compensation from An Accounting Perspective

History of Accounting for Stock-Based Compensation

Accounting guidance surrounding stock options and other equity-based compensation has been around for decades, and during that time, has created fire storms of debate and protest. For most of those years, the authoritative guidance was outlined in Accounting Principles Bulletin (APB) 25, dated June 1972, and updated in 1995 with Statements on Financial Accounting Standards (SFAS) 123. Under this guidance, it was recommended, but not required, that the fair value of stock options be included on a company's income statement as compensation expense.

In practice, substantially all companies elected not to account for stock options at fair value, which usually resulted in no expense being captured in the financial statements. This, in part, led many companies to lavishly use stock options as a means of compensating corporate officers and other key managers by offering incentives that impacted neither the Company's cash flows nor the reported earnings, while still providing a tax deduction for the gain recognized by the employees.

One of the most significant problems with the old guidance was the availability for companies to use, instead of fair value, an "intrinsic value" method of determining the value of the stock options, which was simply the excess of the market price of the stock over the exercise price of the option. Since most options were issued at the current market price or a higher price, the value of the option would be determined to be zero, and no expense was recognized in the income statement.

In the aftermath of accounting and business scandals in the early 2000s, many public companies elected to begin reflecting stock options at fair value. By 2005, new accounting guidance (now codified under Topic 718 of the Accounting Standards Codification) required the use of a fair-value-based method to record equity-based compensation. More specifically, equity-based compensation is to be determined using the fair value at the grant date and expensed over the required period of service. For the past 10 years, the use of stock options and similar arrangements continues to be an important, and now more transparent, component of employee compensation.

Accounting Considerations

As can be seen from the historical accounting perspective, the determination of value for equity-based compensation has been at the forefront of the accounting and financial reporting debate. A detailed explanation of the different fair value methodologies will be presented in Chapter V. Here, we will take a look at the other issues that factor into the accounting for stock-based compensation.

The Ins and Outs of Non-Cash Compensation

As we discussed in previous chapters, companies may establish formal plans that issue actual equity units, the right to buy such units, or provide compensation based on the value of these units. The form of these arrangements will depend on the purpose of the compensation and to whom the compensation is being provided. Many equity-based arrangements are designed to provide incentives that align the employees' efforts with the performance of the company. These incentives may be broadly offered or focused on officers and key employees. We have already discussed the various benefits of including equity-based compensation in an employee's compensation package.

Other equity-based arrangements may involve outside parties such as vendors, lenders, investors, board members or consultants, rather than employees. Accounting for these transactions falls under separate guidance that will be discussed briefly at the end of this chapter.

Generally, the primary factors that impact how companies account for stock-based compensation to employees center on determining the timing for recognition of any expense, allocating that expense over the relevant time period, and calculating an appropriate fair value to be recognized. In addition, financial statement disclosures required for these plans may also be very detailed.

Service Period and Vesting

Equity-based compensation often stipulates a period of time during which an employee must provide services to the company in exchange for the award. This is the ***requisite service period***, and it is used to determine when the company recognizes the cost of the award in its financial statements.

Similarly, an equity award may have stated ***vesting*** provisions that govern when the units become exercisable by the employee. For example, stock options with a three-year vesting period may be cliff-vested (meaning that all options vest at the end of the three-year period), vest evenly over the term (i.e., one-third of the options vest each year), or possibly have a graded vesting provision in which 25% of the options vest in each of the first two years, with the remaining 50% vesting in the third year.

The manner in which options or other equity awards vest does not change the fact that compensation is to be recognized over the service period. However, different vesting provisions could alter the amount recorded in each of those years. Further, vesting provisions may add complexity to the accounting for stock options because the determination of fair value would differ for each group of options (although weighted averages are also permitted).

The Ins and Outs of Non-Cash Compensation

The company must also consider whether a portion of the options will be forfeited due to employee turnover during the service period. Anticipated turnover must be estimated and incorporated into the calculation of equity-based compensation expense, and this estimate must be updated throughout the service period with a final reconciliation of estimated amounts to the actual outcomes at the end of the service period. Combined with graded vesting provisions, these calculations can be cumbersome to prepare.

While our discussion has focused on employee service as the basis for determining the service period, equity awards may introduce other performance measures for achieving exercise rights, such as reaching specific operating targets or the occurrence of a specified but uncertain event. The determination of a service period for purposes of recognizing compensation expense should factor in the probability of achieving performance measures or events, and the estimated service period would be reviewed and updated each year until the awards have either vested or expired.

Determination of Fair Value

Equity-based compensation should be reflected at the fair value of the equity instruments conveyed for the services. The value of the services provided in exchange for the equity is not an acceptable basis for recording these types of transactions. Determining the fair value of these awards can be complex if there is not an active market for the awards. Different valuation models can be used; these models utilize multiple assumptions and other inputs that may be more difficult for non-public companies to quantify. Chapter V will delve into the valuation techniques and considerations relevant to equity-based compensation.

The fair value of equity-based awards is based on the ***grant date***. The grant date is the date on which the employer and employee have a mutual understanding of the terms of the award, and the employer has a commitment. The date on which the award is approved may also be considered the grant date if the employee has no performance obligation (aside from perhaps a service period) and is notified within a relatively short period of time.

Fair value will also consider any restrictions placed on the awards, such as the lack of transferability. However, restrictions related solely to the vesting period or forfeitures are not factored into the valuation itself, as they are already captured in the accounting considerations discussed earlier.

If the fair value of an equity instrument cannot be reasonably estimated at the grant date because of the complexity of its terms, then the company may record the instrument using the intrinsic value method, which computes the difference between the market price and the exercise price. This value would be remeasured each subsequent period throughout the requisite service period, and the change in value (resulting from changes

The Ins and Outs of Non-Cash Compensation

in the market price) would be reflected as compensation expense for that period. When the instrument is exercised, the value would be adjusted one final time to reflect the difference between the market price of the stock and the exercise price of the option.

As will be demonstrated in the upcoming example, the intrinsic value method can result in an expense that differs significantly from the fair value method, both annually and in total, for the service period. Further, the total compensation expense is not known at the grant date because it is ultimately based on the future market price of the stock; thus, this method exposes the company to a significant amount of uncertainty and lack of control regarding the equity-based compensation expense reflected in the financial statements. Combined with the availability of commonly-accepted valuation methodologies and in keeping with the spirit of the accounting guidance, fair value should be used whenever possible. The use of a qualified valuation professional is highly recommended to assist in determining appropriate inputs and performing these complex calculations, especially as they become more substantial.

Tax Considerations

For many equity-based compensation arrangements, there is a tax deduction available to the companies as employees exercise the rights conveyed under the equity instruments. Under current accounting guidance, the tax impact of transactions must also be recorded, even if the tax deduction or tax charge will occur (or may occur) at a future date. These future tax benefits are referred to as ***deferred tax assets***. A company must consider and properly reflect the tax effect of stock transactions as the compensation expense is being recorded. This aligns the future tax benefit with the current book expense. The consideration of income taxes introduces additional complexity to the process, as the company must estimate the tax rate to be applied and the probability that the deductions will be realized by the company. Chapter IV provides further detail on tax implications.

Example Using Stock Options

Stock options are a specific type of equity-based compensation under this accounting guidance. While not stock themselves, they are rights to purchase stock and can be granted to employees (or non-employees, as discussed later) for a number of incentive and cash flow reasons. An example is presented below using a basic stock option plan offered by a tax-paying corporation.

- ABC Company authorizes a plan that permits the Company to grant 1,000,000 stock options to key employees for the purchase of shares of ABC Company's no-par common stock. The exercise price of the stock options is $0.80 per share and vests after three years.

The Ins and Outs of Non-Cash Compensation

- On January 1, 2016, the Company grants 500,000 options to five members of management. At that date, the fair value of the common stock was $0.44, and the fair value of the stock options was $0.40. The Company estimates that 90% of the options will vest, based on anticipated retention of the employees.

- The total fair value of the granted stock options is $200,000, and the total expense expected to be recognized by the Company is $180,000 (90%). The annual expense recorded by the Company is $60,000:

Compensation Expense	$ 60,000	
Additional Paid-In Capital - Options		$ 60,000

  If the options vested incrementally over the three-year period, the retention rate and the annual expense would be computed for each group of options separately using the same process.

- ABC Company is a tax-paying corporation and expects to utilize the deduction that will be generated when the employees exercise the options. Since a future deduction is expected and available, the Company records the future tax benefit of the current year compensation expense as a reduction of its income tax expense and a tax asset to be utilized when the options are exercised. At a tax rate of 35%, the Company records a $21,000 ($60,000 x 35%) tax benefit each year:

Deferred Tax Asset	$ 21,000	
Deferred Tax Expense (Benefit)		$ 21,000

  The above entries are made for each of the three years, provided that there are no changes in the estimated retention rate. Changes in the fair value of the common stock or the stock options are not relevant to the accounting for this award.

- After three years, the options are fully vested, and 100% of the options are exercised. The fair value of the common stock, which is used for the purchase of the shares, is $1.30. The amount received by the Company is $400,000 (500,000 options x $0.80 exercise price). The Company will also reclassify the paid-in capital recorded for the options into common stock. The Company will record an additional $20,000 of compensation expense to adjust for the difference between the estimated number of options exercised (90%) and the actual number exercised (100%).

Cash	$ 400,000	
Additional Paid-In Capital - Options	180,000	
Compensation Expense	20,000	
Common Stock		$ 600,000

The Ins and Outs of Non-Cash Compensation

- The total equity recorded by the Company is $600,000. Had the shares been purchased in the open market, the Company would have received $700,000 (500,000 shares x $1.40). The difference results from the estimated fair value of the stock options at the grant date, which was $200,000, and the below-market price savings of $300,000 (500,000 shares x $0.60 savings per share) realized by the employees at the exercise date. Such differences demonstrate the impact of changes in the marketplace, which are appropriately not a component of the Company's reported earnings.

- The Company must also recognize the realized tax benefit resulting from the exercised options. The deduction taken by the Company equals the gain to the employees. As noted above, this was $300,000, which would generate a tax benefit of $105,000 at 35%. A deferred tax benefit of $63,000 has already been recorded during the service period, which leaves an additional $42,000 to be recognized in the year that the options are exercised:

Deferred Tax Expense (Benefit)	$ 63,000	
Current Taxes Payable	180,000	
Current Tax Expense (Benefit)		105,000
Deferred Tax Asset		$ 63,000

- Note that the Company reduced its current year tax liability by the full $105,000 benefit from the deduction for the stock options. The income tax benefit reflects the change in the estimated retention rate noted above, as well as the change in the market price of the common stock.

As can be seen in this example, an adjustment was made at the end of the service period to reflect the vesting of 100% of the options as opposed to the estimated 90%. This adjustment is made without regard to whether the vested options would actually be exercised. The presumption is that the options will be exercised. The recognition of an equity-based transaction should not be reversed if the equity rights conveyed are not exercised. The increase in paid-in capital remains on the books.

Other Common Equity-Based Compensation Arrangements

As discussed previously, other methods of incentivizing and compensating employees exist aside from stock option plans. In many of these cases, the accounting may be more straight-forward due to the lack of complexity of the arrangements (although the computation of fair value may be equally complex).

- ***Stock Bonus/Restricted Stock*** – Stock bonuses and restricted stock awards both involve the immediate granting of equity to the employees, unlike stock options that only convey future rights to acquire equity.

The Ins and Outs of Non-Cash Compensation

- Under a stock bonus plan, a company will issue an award of stock to an employee that is fixed and determinable (e.g.,100 shares or $5,000). There is no service or vesting period or other performance requirements to be fulfilled. Under this simple arrangement, the fair value of the stock (less any nominal amount that the company may require the employee to pay) is recorded as compensation expense at the time of the award.
- Restricted stock awards also involve the immediate granting of equity to the employee, but may be subject to forfeiture if certain service or performance conditions are not met. The fair value of restricted stock is adjusted based on the nature of the restrictions.

• *Employee Stock Purchase Plans* – At their simplest level, these plans merely allow employees to purchase company stock, often at a discount. Accounting for stock purchase plans requires the company to estimate both the fair value of the discount and the number of shares that will be purchased under the plan over the period of availability.

Plans constructed to enable employees to purchase shares of the Company's stock are not necessarily compensatory, and in such cases no compensation expense would need to be recognized by the Company. For this to be true, the plan must not contain terms or features that are more favorable than would be available to all other stockholders of the same class. Favorable terms would include significant discounts from the market price (i.e., more than 5%) or look-back options that permit the employee to pay the lesser of the market price at the date of the grant or the purchase date. The existence of any favorable terms would add value to the purchase rights granted to the employees, which would need to be valued and treated as compensation.

In order to be noncompensatory, the plan must also have limited employment qualifications, so as to not be exclusionary or discriminatory.

• *Stock Appreciation Rights/Phantom Stock Units* – These types of plans generally provide cash compensation rather than conveying equity, or the rights to acquire equity, to the employees (although they can be settled in stock at an equivalent value). They are equity-based because the cash compensation is derived from the change in the fair value of the company's equity over a specified period. The expense related to stock appreciation rights is recognized over each reporting period based on the change in equity value. Phantom stock units often include performance requirements or other contingencies. The company must assess the probability of occurrence, as well as the service period, and calculate the fair value accordingly. The expense, like stock options, is recognized over the service period and adjusted as the estimates are revised.

The Ins and Outs of Non-Cash Compensation

Equity Compensation to Non-Employees

The focus of this chapter has been on accounting for employee compensation. However, equity-based arrangements may also be used as compensation for vendors or other parties providing goods or services to the company. The 2005 accounting guidance related to equity-based compensation did not extend to transactions with non-employees. Instead, Topic 505 of the Accounting Standards Codification governs the treatment of equity transaction with non-employees.

The equity transactions are generally recognized when the goods are received or over the period of service, similar to employee compensation. Unlike employee compensation, though, the fair value to be used may either be based on the value of the equity instruments conveyed or the value of the goods or services delivered. Whichever value is more readily determinable should be used to record the transaction.

It is also possible for the company to grant fully-vested equity instruments in advance of any performance by the recipient. In such cases, the transaction would be recorded at the earlier date (e.g., as a prepaid expense), and separate guidance applies to the changes in value from the initial measurement to the date of performance by the vendor.

Concluding Thoughts

The accounting requirements pertaining to equity-based compensation can be complex and varied, depending upon the form of the arrangement. Equity transactions that may not involve cash, and may not be settled until a future period, will still affect the current accounting and financial reporting process. Proper treatment of these transactions necessitates clear communication of the terms of the plan to those responsible for preparing the financial statements. It is advisable to consider the accounting impact when establishing such plans in order to avoid unintended financial consequences.

The Ins and Outs of Non-Cash Compensation

IV. Equity-Based Compensation from A Tax Perspective

From an income tax perspective, non-cash compensation of any type reflects an economic gain to the recipient. As such, the gain constitutes taxable income to the recipient under the Internal Revenue Code of 1986, as amended (IRC or "the Code"). The guiding principle in these assessments is economic enrichment obtained in exchange for the provision of personal services by the recipient. As will be discussed throughout these materials, the income tax effect of receiving non-cash compensation (that, is, ordinary income) is the same whether the non-cash remuneration is paid to an employee or an independent contractor. While the primary elements of this program focus on tax treatment of non-cash equity-based compensation paid to employees, it must be remembered that similar rules apply to independent contractors rendering personal services to a taxpayer in that capacity.

Individuals who are paid for their personal services with stock or other property, or who exchange their services for the services of another, must treat the value of the property or services received as income under IRC §61(a)(1) and Treasury regulation §1.61-2(d)(1). Generally, under this regulation, the amount included in income is equal to the fair market value of the property.

Pursuant to IRC §83, property received in connection with providing services, but subject to restrictions that affect its value, is not included in income until the recipient's rights to the property have substantially vested. Property transferred by an employer to an employee for an amount less than its fair market value requires that the difference between the fair market value and the amount paid for the property (if any) be treated as compensation to the employee.

Understanding Fair Market Value

In conjunction with the determination of the "income" element received by any individual providing personal services, it is first necessary to establish a threshold measurement metric. In the case of income tax-based valuations, this standard of value is fair market value. Fair market value is generally defined as follows:

> *The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at 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.*

The determination process associated with finding fair market value will be discussed later in these materials.

The Ins and Outs of Non-Cash Compensation

Property Transferred in Exchange for Personal Services

The primary guidance governing non-cash compensation is IRC §83 – *Property Transferred in Connection with Performance of Services.* Under this provision of the Code, a service provider must include in taxable income the fair market value of any property that the service provider received in exchange for personal services rendered to the transferor of the property. The provision carries three primary elements for applicability:

1) There must be property involved
   - Includes both real and personal property
   - Excludes cash money and unfunded and unsecured promises to pay money
2) There must have been a transfer of property
   - Generally refers to when the service provider acquires beneficial ownership
   - Generally means transferee must be entitled to participate in the potential upside via asset/property appreciation and also be subject to risk of loss (from a potential decrease in value)
3) The transfer must have been for the performance of services
   - As noted, applicable to both employees and independent contractors
   - Applicable to future, present and past services

Examples of non-cash compensation include restricted stock plans, nonstatutory stock options, nonqualified funded plans (i.e., using insurance or "assets or funds irrevocably set aside from the claims of a creditor or the promise") and stock appreciation rights. Items that would constitute exceptions to IRC §83 include incentive stock options, nonqualified unfunded plan money or unsecured promises to pay money in the future.

Generally, IRC §83 requires that the employee or independent contractor recognize compensation (ordinary income) in an amount equal to the excess of the fair market value of the property received (and to which the transferee has beneficial ownership) over any amounts the transferee might be required to pay for the property

By way of example, assume Employee A does an excellent job in 201X, and the employer elects to give Employee A unrestricted and immediate beneficial ownership interest of 100 shares of employer stock valued at $50 per share. There is no requirement for Employee A to pay anything for the shares. Thus, under the general rules of IRC §83, Employee A recognizes taxable compensation income of $5,000 in the year of transfer.

Special planning opportunities apply when the property transferred is not fully vested or the property is subject to certain types of restrictions. These opportunities are explained in the next section of these materials.

The Ins and Outs of Non-Cash Compensation

Non-Cash Property Subject to Restrictions

Special rules apply to stock or other property that is transferred to an employee or independent contractor, in connection with the performance of services, and that is subject to restrictions affecting its value. In this situation, amounts are included in income when the property has substantially vested.

Substantial vesting, pursuant to IRC §83(a) occurs when:

(1) the recipient can transfer rights to the property; or

(2) the rights to the property are not subject to a "substantial risk of forfeiture."

The includible amount of income is equal to the fair market value of the property, less any amount paid for the property.

Restricted Property/Substantial Risk of Forfeiture

Property transferred to an employee as compensation is often subject to certain restrictions creating substantial risks of forfeiture and restraints on transferability. This type of property is generally known as "restricted property." As noted above, payments in the form of restricted property are generally not included in the employee's income and are not deductible by the employer until the property is no longer restricted.

Property generally is considered subject to a significant risk of forfeiture if an employee must perform substantial future services for the employer before he or she has a right to the full enjoyment of the property. Property generally is considered to have a restraint on transferability if an employee is restricted from transferring his interest in the property to any person other than his employer.

If transferred restricted property is not substantially vested, the payer entity/corporation cannot claim a compensation deduction, and the employee is not required to recognize income with respect to that property.

Property becomes substantially vested on the earlier of:

(1) the date the substantial risk of forfeiture lapses; or

(2) the date the property becomes transferable.

Note, that until he property becomes substantially vested, the employer is treated as the owner of the property.

Once the property becomes substantially vested, the employee recognizes income equal to the fair market value of the property received, less any amount paid for that property, and the employer can deduct the amount that the employee must include in income.

The Ins and Outs of Non-Cash Compensation

Property that is transferred in connection with the performance of services may have certain restrictions on transferability that will never lapse. Such "non-lapse restrictions" ***do NOT*** prevent an employee from substantially vesting in the property. They simply affect the determination of the fair market value of the property for purposes of determining the employee's compensation income and the employer's compensation deduction.

Non-lapse restrictions are permanent limitations on the transferability of property that:

(1) require the employee to sell, or offer to sell, the property at a price determined under a formula; and

(2) continue to apply against the employee or any subsequent holder.

One specific type of non-lapse restriction involves a limitation subjecting the property to a permanent right of first refusal by a particular person at a price determined under a formula.

Recognition of Taxable Income Prior to Substantial Vesting

As an alternative to postponing the inclusion of income until substantial vesting occurs, IRC §83(b) allows a taxpayer to elect to include the excess of the property's fair market value over any amount paid for the property in income in the year in which the property is received. Thus, an employee or independent contractor can elect to have the excess of the fair market value of the restricted property over his cost taxed to him in the year it is received, even though the property remains substantially nonvested.

Such an election (early inclusion of ordinary income) would be prudent if the recipient of the property expects that the property will appreciate significantly between the date (tax year) that he or she is including the fair market value of that property in taxable income and the date (tax year) where he or she substantially vests in the rights to the property. The primary point of making the election under IRC §83(b) is to recognize, as compensation subject to ordinary income rates, a smaller amount of income than would be recognized by waiting until the property is substantially vested.

The IRC §83(b) Election

To invoke the early inclusion, it is necessary for the recipient of the property to make a formal election to do so – the §83(b) election. If a valid election is made, then any subsequent appreciation in the value of the property after the initial inclusion amount does not result in additional compensation; rather, it constitutes capital gain. Depending on the holding period at the later date of sale or exchange, the capital gain may be taxed at preferential rates.

The Ins and Outs of Non-Cash Compensation

To ensure that the benefits of IRC §83(b) are obtained, Treasury regulation §1.83-2(b) provides that the formal election must be made no later than 30 days after the property is transferred. A proper election is made by filing two copies of a written statement with the Internal Revenue Service Center where the taxpayer files his or her return – one at the actual time of the election and one with the tax return for the tax year in which the property was transferred.

The Internal Revenue Service has proposed "additional" regulations, Proposed Reg. §1.83-2(c) NPRM REG-135524-14, that eliminate the current requirement that a copy must be filed with the taxpayer's tax return. These proposed regulations are intended to apply on or after January 1, 2016 (on which taxpayers may rely for property transferred on or after January 1, 2015).

In addition to stating that the election is being made under IRC §83(b), the statement must include the following information, as required by Treasury regulation §1.83-2(e):

(1) Name, address and taxpayer identification number;

(2) Description of each property for which the election is being made;

(3) Date (or dates) when the property was transferred and the taxable year for which such election was made;

(4) Nature of restriction or restrictions on the property;

(5) Fair market value of property (determined without considering any restriction other than one which will never lapse) at the time of transfer;

(6) Amount of consideration paid for the property; and

(7) Statement that required copies have been provided.

The person who performed the services must give a copy of the written statement to the person for whom the services were performed. If the person who performs the services and the person who receives the restricted property are not the same, Treasury regulation §1.83-2(d) requires that a copy of the statement be given to the one receiving the property by the one who performed the service.

The Internal Revenue Service has provided sample language that may be used for making the election. When properly completed and signed by the service provider, the sample election satisfies the regulatory requirements with respect to shares of common stock subject to a substantial risk of forfeiture. For the election to be valid, the service provider must also satisfy all the other applicable requirements, including timely filing the election with the Internal Revenue Service, attaching a copy of the election to the tax return, and providing a copy to the service recipient.

The Ins and Outs of Non-Cash Compensation

Note that while a valid IRC §83(b) election must contain all the information required by the regulations, Revenue Procedure 2012-29 notes that proper compliance does not require the use of the exact format or language of the sample election.

Once a proper election is made, it is binding and cannot be undone without the consent of the Internal Revenue Service. Generally, the only basis for revocation is a mistake of fact regarding the underlying transaction. Such a mistake does not, however, include a mistake as to the value, or decline in the value, of the stock or property. In addition, as set out in Treasury regulation §1.83-2(f), a failure to perform an act contemplated at the time of the transfer does not constitute a mistake of fact. The request for revocation must be made within 60 days of the date on which the mistake of fact first became known to the person who made the election.

Tax Implications of the IRC §83(b) Election

As noted earlier, if a recipient employee/independent contractor chooses to make the IRC §83(b) election, the general restricted property rules do not apply, and later appreciation in the value of the property is not treated as compensation. Also, it is important to note that subsequent dividends are treated as dividends rather than compensation for services under Revenue Ruling 83-22. If the property is later forfeited, an ordinary loss deduction will NOT be allowed.

The fair market value of property with respect to which an IRC §83(b) election has been made is includible in gross income as of the time of the transfer, even though that property is substantially nonvested at the time of the transfer. Further, Treasury regulation §1.83-2(a) rules that no compensation will be includible in gross income when the property becomes substantially vested. If there is a failure to vest and, as a result, an employee who made the election later has to sell the property back for what the employee paid for it, there is no taxable gain resulting from the sale to the employer, even if the value of the property has appreciated.

If the employee has to forfeit the property, there is no tax deduction or credit available due to the loss or to previously-paid taxes. In the event that the property is later disposed of in a sale or exchange, it is critical that a proper basis computation be available for that property. In determining gain or loss from the subsequent sale or exchange of such property, its original basis is the amount paid for the property, plus the amount included in gross income as a result of the election.

If the property is forfeited by the recipient before it is substantially vested, then Treasury regulation §1.83-2(a) dictates that the amount of the loss is equal to any excess of the amount paid for the property over any amount realized upon the forfeiture.

The Ins and Outs of Non-Cash Compensation

Employer Tax Deductions for Compensation Paid with Property

When employees are required to report as income, compensation paid to them in either cash or property, the employer is entitled to a corresponding deduction. If the property is restricted, as noted above, IRC §83 determines how much income the employee must report and the timing of the deduction.

Pursuant to that provision, in the case of a transfer of property to which IRC §83 applies or a cancellation of a restriction described in subsection (d), there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection with which such property was transferred, an amount equal to the amount included under subsection (a), (b), or (d)(2) in the gross income of the person who performed such services. Such deduction shall be allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed such services.

The key element for ensuring the deduction for non-cash compensation is the matching of the timing of the income recognition event for the recipient and the deduction year for the company for whom the services were performed.

Employer Tax Treatment

Generally, the employer entity providing the non-cash compensation is allowed a compensation deduction for the year that includes the end of the year in which the employee includes the compensation in income (but only if the amount otherwise meets the requirements for deductibility of compensation). The deduction is equal to the amount of income the employee recognizes.

Non-lapse restrictions place a permanent limitation on the transferability of property. As noted earlier, such restrictions are not considered to subject transferred property to a substantial risk of forfeiture.

However, non-lapse restrictions are considered when determining the fair market value of the property on the date of transfer. Non-lapse restrictions tend to cause the value of the property to be lower than it would be without the restrictions. A non-lapse restriction includes a limitation requiring the employee to surrender stock received in connection with the performance of services whenever the employee leaves the corporation as well as a limitation subjecting the property to a permanent right of first refusal at a price determined under a formula. An obligation to sell at fair market value is not a non-lapse restriction.

The Ins and Outs of Non-Cash Compensation

All Events Test and Accrual of Income

General tax rules under IRC §451(a) provide that the method of accounting used by a taxpayer governs the tax year in which an item is reported as income. Under the accrual method, items are included in income in the tax year in which the "all events test" set forth in IRC §461(h)(1) occurs. This tax provision provides that the all events test is generally not met until economic performance takes place. In the case of services provided to the taxpayer, economic performance takes place as the services are provided to the taxpayer.

Note, that these rules could potentially be at variance with IRC §83(h), which, as noted above, provides that the employer is allowed a deduction in the year the transferee takes the property into income. Under the former IRC §461 proposed regulations, the employer could take a deduction upon the satisfaction of the §83 requirements or the occurrence of economic performance, whichever occurs later.

The preamble to the final IRC §461 regulations does provide some guidance in this area. It states that generally the IRC §83(h) specific timing rules should take precedence over the economic performance rules in some cases (e.g., if a IRC §83(b) election is made.) However, the authors would caution the attendees of today's program that this is an area of concern to the Internal Revenue Service and should be navigated carefully.

Exceptions

Numerous exceptions to the general rules exist and must be considered in conjunction with determining the income tax affects of non-cash compensation. The restricted property rules do not apply to transfers involving statutory stock options, qualified pension or profit-sharing plans or stock bonus trusts, qualified annuities, options with no readily-ascertainable fair market value, property received through the exercise of an option that had a readily-ascertainable fair market value when it was granted and certain group-term life insurance.

Statutory Stock Options (Incentive Stock Options or Qualified Stock Options)

There are numerous special rules that may apply to stock options that are presented to employees. The income tax treatment of stock options generally turns on whether the option is a statutory or a nonstatutory stock option. In general, an employee does not realize income upon the receipt of a statutory stock option, while income is realized from a nonstatutory stock option when its fair market value is determinable.

To better understand the tax implications of stock options, it is first necessary to understand the definition of an option. An option is defined in Treasury regulation §1.421-1(a) as an offer made to an employee by a corporation, or by its parent or subsidiary corporation, or another legal entity to sell stock or equity of any such

The Ins and Outs of Non-Cash Compensation

entities at a stated or determinable price, with the offer continuing for a stated period of time and the employee being under no obligation to purchase the stock.

No particular form is required for the option, but the option right or privilege must be evidenced in writing (in either paper or electronic form). For the protection of both the optionee and optionor, the option terms should be specific and contain, among other items, the name of the optionee and optionor, the maximum number and kind of shares involved, the option price, the date that the option is granted and the period of time during which the offer is to remain open.

Treasury regulation §1.421-1(d) requires that the stock subject to a statutory option must be capital stock, but it may be voting or nonvoting common or preferred stock, treasury stock or stock of original issue. Special classes of stock authorized to be issued to and held by employees may qualify if they otherwise possess the right and characteristics of capital stock.

The "option price" is the consideration, either in money or property, that the option terms set as the price at which the stock subject to the option may be purchased. The option price does not include, per Treasury regulation §1.421-1(e), amounts paid as interest under deferred payment arrangements or amounts treated as imputed interest under IRC §483 where no interest, or an unrealistically low rate of interest, is provided under a deferred payment arrangement.

Generally, an option is deemed granted on the date or at the time when the corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. For the purpose of determining when an option is granted, a corporation completes the corporate action when, pursuant to the terms of its offer, the number of shares of stock that may be purchased is fixed and determinable.

Statutory stock options offer significant tax advantages over nonstatutory stock options. To qualify for the special tax treatment applicable to statutory stock options, per Treasury regulation §1.421-1(h), the optionee must be an employee of the granting corporation or of its parent or subsidiary at the time of the granting of the option and must remain in employment of the grantor or a related corporation until within three months of the time that he/she exercises the option. For purposes of the employment requirement, a corporation employing the optionee is considered to be a related corporation if it was a parent or subsidiary of the grantor corporation during the entire portion of the requisite period of employment during which it was the employer of the optionee.

The Ins and Outs of Non-Cash Compensation

General Tax Rules for Statutory Stock Options/Incentive Stock Options

An incentive stock option can have both regular tax and alternative minimum tax (AMT) implications.

For regular tax purposes, statutory stock options, incentive stock options (ISO) and employee stock purchase plans are generally given special tax treatment. Statutory stock options are usually not taxed until the recipient disposes of the options, and any gains on the disposition are then taxed as capital gains.

For AMT purposes, the difference between the option price and the fair market value on the date the option is exercised (unless the stock is subject both to restrictions on transferability and a substantial risk of forfeiture) is a positive AMT adjustment, increasing alternative minimum taxable income (AMTI), which may trigger AMT in the year an incentive stock option is exercised [IRC §56(b)(3)]. The taxpayer's stock basis for AMT is fair market value at the date of exercise (cost plus amount included in AMTI as an adjustment). A taxpayer disposing of the stock will have a negative AMT adjustment for the excess of the basis for AMT over the basis for regular tax. If the stock is disposed of in the same year as exercise, the two adjustments will offset, and the tax effect will be the same for both regular tax and AMT. A taxpayer may avoid the application of AMT resulting from an incentive stock option exercise by staggering it over multiple tax years to ensure that the adjustment does not trigger AMT.

In stark contrast to this treatment, nonstatutory or nonqualified stock options, governed by the general rules of IRC §83, as noted earlier in these materials, are not given similarly favorable tax treatment. As noted, these options are generally taxed as ordinary income at the time they are granted since they are considered to be compensation for services rendered by the employee. Pursuant to Treasury regulation §1.83-7(a), nonstatutory stock options may also be taxed when the employee exercises the option, when the employee sells or otherwise disposes of the option, or when restrictions on disposition of the stock lapse.

With respect to a transfer of stock pursuant to a statutory stock option, it is noteworthy that the transfer itself is not a taxable event. Thus, no income is received by an employee when he or she exercises his or her option within the required time limits under IRC §421(a).

Pursuant to IRC §421(a)(2) and Treasury regulation §1.421-2(a), where stock is transferred pursuant to a statutory stock option, the employer corporation may not take a business deduction with respect to such transfer, and no amount other than the price paid under the option may be considered as received by the corporation for the stock transferred.

The Ins and Outs of Non-Cash Compensation

Since the grant and exercise of a statutory stock option are generally tax-free events for an employee, taxation is usually deferred until the stock is sold. However, income will be deemed realized if the employee dies while holding stock acquired under an employee stock purchase plan option where the option price was less than 100% of the fair market value of the option stock at the time of the option grant [IRC §423(c)].

In these instances, if an employee dies while holding a statutory stock option, and the option can be transferred by will or the laws of descent and distribution, the option will retain its status as a statutory stock option in the hands of the estate or other person who acquires the option by reason of the death of the deceased employee. Thus, if the option is distributed by the estate to an heir as part of the estate, the option remains a statutory stock option. But, if the estate or heir sells the option, the option will cease to be a statutory stock option.

The estate or heir who succeeds to the option is subject to the same rules that would have applied to the deceased employee in all but two respects:

(1) the employer-employee relationship does not apply to the estate or heir – thereby, negating the requirement that a statutory stock option be exercised within three months after the termination of the deceased employee's employment; and

(2) the holding period requirements otherwise applicable to stock acquired under a statutory stock option do not apply to the estate or heir.

The estate or heir, however, is still bound by the holding period applicable under the capital gains provisions to determine whether the gain or loss upon disposition of stock acquired under a statutory stock option is entitled to long-term capital gain or loss treatment.

If stock acquired under a statutory stock option is disposed of before the expiration of the holding period applicable to the particular statutory stock option, a disqualifying disposition of stock occurs, and a *special* tax rule applies. Generally, this means that the spread between the option price and the fair market value of the stock at the time of exercise of the option will be reportable as compensation (and the deduction will be allowable to the employer corporation) in the year of the disqualifying disposition per IRC §421(b).

On the other hand, in the case of an incentive stock option, the amount includible as compensation may not exceed the difference between the amount realized on the disposition of the stock and the employee's adjusted basis (generally cost). Thus, where the sale price of stock is less than the fair market value of the stock at time of exercise of the option, the amount reportable as compensation (and deductible by the employer corporation) is limited to the amount of gain realized on the sale [IRC §422(c)(2)].

The Ins and Outs of Non-Cash Compensation

With respect to the employer corporation granting the option, Treasury regulation §1.421-2(a)(1) governs. Under this provision, the granting of a statutory stock option, or the exercise thereof by an employee, does NOT result in a business deduction for the grantor corporation or for a corporation that assumed or replaced a statutory stock option in a corporate merger, reorganization or liquidation.

The only time that the grantor corporation can take a business deduction is when the employee disposes of the stock acquired pursuant to a statutory stock option prior to the expiration of the holding period applicable to the particular option involved. Upon such a disqualifying disposition, the corporation is considered to have paid compensation to the employee to the extent of the amount that the employee must report as compensation realized from the disposition. To the extent that this amount qualifies as a business expense, it is deductible by the employer corporation [Treasury regulation§1.421-2(b)].

Inclusion of Deferred Compensation under Nonqualified Deferred Compensation Plans

Nonstatutory stock option plans may fall under the purview of nonqualified deferred compensation plans. When this circumstance arises, IRC §409A comes into play and must be considered.

IRC §409A applies to compensation that workers earn in one year, but that is paid in a future year. This is referred to as nonqualified deferred compensation. If the deferred compensation plan meets the requirements of §409A, there is no effect on the employee's taxes. The compensation is taxed in the same manner as it would be taxed if it were not covered by §409A. If the arrangement does not meet the requirements of §409A, the compensation is subject to certain additional taxes, including a 20% additional income tax. The provisions of §409A have no effect on FICA (Social Security and Medicare) tax.

Generally, IRC §409A imposes timing restrictions on applicable plans in three main areas:

1) restrictions on the timing of distributions;
2) restrictions against the acceleration of benefits; and
3) restrictions on the timing of deferral elections.

IRC §409A does provide some exemptions from its applicability, including:

- Incentive stock options and employee stock purchase (IRC §423) plans
- Nonqualified stock options with an exercise price at least equal to fair market and that meet certain other requirements

The Ins and Outs of Non-Cash Compensation

A detailed discussion of the income tax implications of IRC §409A is beyond the scope of today's program. However, it is critical that this section of the Internal Revenue Code be given due care in assessing the income tax implications of non-cash compensation programs involving equity and stock options.

Taxation of Stock Appreciation Rights/Phantom Stock Plans

Stock appreciation rights (SARs) and phantom stock plans offer businesses an alternative means to allow key executives share in the economic fortunes of the employer/company, while allowing the current owners to maintain their original ownership in an undiluted manner. Additionally, like stock options, both SARs and phantom stock plans allow the company to place restrictions on the payments via a vesting period.

SARs allow each executive to share in the value increase in the stock price applied to a specific number of shares. The company would then pay that key employee at the time he or she exercises the right under the plan. The payment will be the difference between the current stock value less the stock value at the time of grant.

Much like SARs, a phantom stock plan provides the executive with a certain number of shares without any actual transference of ownership. Unlike a SARs plan, a phantom stock plan is generally offered for a discrete time frame. The key executive would receive a credit for any dividends that are paid on the outstanding shares of stock during the discrete period, and when the time frame expires, he or she would be credited via a cash payment equal to the value growth in the company's stock.

As both vehicles settle in cash, under SARs and phantom stock plans, recipient key executives have ordinary income tax consequences when they receive that cash from the plan. Upon the payment, the company would, of course, receive a corresponding income tax deduction.

The main difference between SARs and phantom stock plans relates to employment taxes, specifically, FICA and FUTA tax. For SARs, the FICA and FUTA taxes are paid when the executive receives cash. For a phantom stock plan, FICA and FUTA payments are paid when the services are performed or the employee is vested in the plan.

Summary

In such an abbreviated presentation, time does not permit a full discussion of the many tax considerations that one should contemplate in determining the tax impact of using this means of compensation. However, the above foundational discussion will allow today's participants to understand key elements of the basic tax scheme within the United States.

The Ins and Outs of Non-Cash Compensation

V. Equity-Based Compensation from a Valuation Perspective

Introduction

In the past, publicly-traded companies were issuing equity-based compensation, and private companies were faced with the issue of talented executives being lured away by public companies offering company stock as a key component of total compensation packages. While the equity in a private company cannot be traded on a stock exchange and may not otherwise be marketable, there are various means by which private companies can provide long-term equity incentives that may also be liquid investments for employees.

The top concerns for privately-held business owners are relinquishing control and having to account to minority shareholders in managing the business. However, as discussed in these materials, there are various means by which to provide long-term equity incentives to employees without ceding control to them.

By offering equity compensation, a privately-held company can (i) compete for talent with larger companies by the prospect of appreciation in the value of the equity, (ii) provide an incentive for employees to perform in the best interest of the company, and (iii) preserve cash resources by paying lower cash compensation.

Valuation work in connection with non-cash compensation (specifically, equity-based compensation) has increased with the trend of companies offering this type of compensation to their employees. While businesses with cash-flow problems have typically used equity-based compensation to attract employees, many companies have additionally begun using equity-based compensation to maintain employees, which was explained earlier in this material.

Many start-up companies in emerging industries (which, in this geographic area, include those operating in the information technology and biotechnology arena) are often funded by angel investors, venture capital and private equity sources. When there are several rounds of financing, 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. Management and investors alike need to be informed about the current value of their investments and the entity's capitalization structure.

Companies are required to adhere to the tax and accounting rules set forth in IRC §409A and Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 718, *Stock Compensation* (ASC 718, formerly FAS 123R), when equity compensation plans are put into place and on an ongoing basis

The Ins and Outs of Non-Cash Compensation

thereafter. As a result, management of these companies engage the services of valuation analysts to determine the value of the equity-based compensation for the purpose of recognizing compensation expenses under generally accepted accounting principles (GAAP) as well as for determining taxable income to the recipient.

Challenges for Valuation Analysts

These assignments can present unique challenges to the valuation analyst. Some of these challenges include:

- ***Capital Structure*** – Companies often have complex capital structures, such as preferred stock or debt securities that may have economic rights including conversion rights, liquidation preferences, right to dividends, mandatory redemption rights, participation rights, anti-dilution rights, voting rights, drag-along rights and veto rights.
- ***Future Outcomes*** – Future plans of management should be considered and may encompass a number of options. Companies can go public, be acquired or merged with another company, fail and liquidate or continue operations as a private company.
- ***Stage of Development*** – Years ago, companies issuing equity-based compensation were typically start-ups in an early stage of development. Currently, there are companies that rely upon proprietary or untested technology as well as mature companies with a proven history of earnings and cash flow.
- ***Industry*** – A company may operate in a new or developing industry. This circumstance would provide little in the way of comparable data that can be used in valuing the subject company.

As always, the authors of this material caution that every valuation assignment is unique and that the purpose of the valuation can introduce nuances that are specific to its purpose. The valuation of equity-based securities is no exception. There are many characteristics, some of which are noted above, that can further complicate the already-challenging task of valuing a privately-held company. The following sections will outline these specific nuances.

Purpose of Valuation

While it is generally understood that valuations can be prepared for many different purposes and that the purpose of each valuation project will drive the methods and approaches applied, it is inappropriate to assume that a valuation that was suitable for one purpose (e.g., estate tax, divorce or potential acquisition) is suitable for another purpose.

The Ins and Outs of Non-Cash Compensation

Valuation analysts may be faced with the challenge of explaining to management of the business that a valuation prepared in connection with another transaction or purpose may not be appropriate in the context of equity-based compensation and the requirements of the Internal Revenue Service (IRS) or GAAP.

Date of Valuation

The date(s) on which the subject equity ownership interest will be valued is critically important because events and circumstances can arise that can cause value to vary materially from one date to another. The date of valuation influences the information available for the valuation. It is the perspective from which all analysis is performed in the valuation.

The date of valuation in connection with the issuance of equity-based compensation is the date on which it is granted, or as close as possible to that date on which it is granted. The valuation analyst is tasked with estimating the fair value (for GAAP) or fair market value (for tax purposes) once employees have (i) rendered the requisite services to the company and (ii) satisfied any other conditions.

Note that a valuation prepared in connection with equity-based compensation can contemplate future outcomes; however, these outcomes must be known or knowable at the date of valuation.

Standard of Value

The standard of value required under IRC §409(a) is fair market value, which is defined as:

> *The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at 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.*

The definition requires that the valuation result be driven by a hypothetical sale transaction. Given that the definition requires consideration of a hypothetical sale, it stands to reason, then, that focus and attention must be given by a valuator to those hypothetical buyers and sellers, as well as to the concerns and issues that a potential hypothetical buyer and seller might consider prior to entering into a transaction.

A key component of this definition is that a value determination based upon special motivations of either a specific buyer or a seller would not be considered fair market value. Fair market value also anticipates that the hypothetical buyer and seller both have the ability, and the willingness, to enter into the hypothetical transaction.

The Ins and Outs of Non-Cash Compensation

The definition of fair market value anticipates a value determination under the prevalent economic and market conditions at a particular date of valuation. To assume an economic or market turnaround at a point in time beyond the date of valuation will result in a value other than fair market value.

The definition also assumes that payment in the hypothetical transaction will be made in cash or its equivalent at the date of valuation. Thus, consideration of any deferred financing or special purchase arrangement is not appropriate when the goal is to identify fair market value.

Finally, fair market value, by definition, must allow a reasonable time for exposure in the open market. For equity-ownership interests requiring longer periods of exposure, marketability, or rather *the lack of* marketability, presents a greater investment risk, and, therefore, a value detriment. Often this value detriment is addressed in the business valuation process as a discount.

ASC 718 requires the determination of fair value for equity securities exchanged for goods and services. The definition of fair value is:

> *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.*

Accordingly, measurements under ASC 718 are considered "fair-value-based" measures, as opposed to fair value measures. The grant-date fair value in share-based payment arrangements does not incorporate vesting conditions into the valuation.

To satisfy the fair value measurement objective, the restrictions and conditions inherent in equity instruments awarded to employees are treated differently, depending upon whether they continue after the requisite service period. Some of these restrictions include the following:

- ***Vesting Versus Non-transferability*** – Restrictions that continue after the equity instruments have been issued to employees (or vested) ***are*** considered in the determination of fair value. An example would be restrictions on transfer of vested stock options or the sale of vested shares (restricted stock). For equity-share options and similar instruments, the effect of non-transferability is taken into account by reflecting the effects of employees' expected exercise and post-vesting employment termination behavior in estimating fair value (referred to as an option's expected term).
- ***Forfeitability*** – Restrictions related to the forfeitability of unearned (unvested) instruments, such as the inability to either exercise a nonvested equity share option or sell nonvested shares, ***are not*** reflected in the fair value estimate at the grant date. These restrictions are taken into account by only recognizing the compensation cost for awards for which employees render the requisite service.

The Ins and Outs of Non-Cash Compensation

- ***Service Conditions*** – A condition affecting the value of the award that depends solely on an employee rendering service to the employer for the requisite service period. An example would be a time-vesting schedule. This ***is not*** considered in measuring fair value at the grant date.

- ***Performance Conditions*** – A condition affecting the value of the award that depends upon the achievement of a specified performance target defined by reference to an employer's operations. An example is vesting based on earnings before interest, taxes, depreciation and amortization (EBITDA) targets. This ***is not*** considered in measuring grant-date fair value.

- ***Conditions*** – A condition affecting the value of the award that depends upon the price of the issuer's shares or amount indexed to the issuer's shares, i.e., a share-price hurdle. This condition ***would be*** considered in measuring fair value at the grant date.

Typically, valuations performed under the fair value standard for financial reporting are used to satisfy the fair market value standard requirement for IRS purposes. As such, the term will be used in the rest of this chapter.

Control Versus Minority

Since equity in privately-held companies issued as compensation is typically represented by minority shares, the valuation will be performed on a minority basis. Further, since the market-participant buyer would not be able to change the company's strategy or obtain synergistic benefits, the valuation should consider the company under current ownership.

The value of the total company in exchange could be higher if potential acquirers had the ability to improve cash flows or recognize synergies in a business combination; however, a minority investor is not able to effect such changes. The market participant or willing buyer contemplated in the fair value definition is the hypothetical buyer for the minority interest, not a hypothetical buyer for the entire entity. Accordingly, the objective is to value the individual securities of the entity, rather than to value the entity itself.

The value of a minority interest is typically determined using a top-down approach, in which the enterprise value is first determined. Then, the fair value of debt is deducted from the enterprise value with the remaining value being allocated to the equity shareholders based upon their economic and control rights.

Valuation Approaches

On May 29, 2013, the AICPA's Financial Reporting Executive Committee issued the *AICPA Accounting and Valuation Guide Valuation of Privately-Held-Company Equity Securities Issued as Compensation* (the Guide), which replaced the 2004 edition of the practice aid on this topic. The Guide provides non-authoritative valuation

The Ins and Outs of Non-Cash Compensation

guidance and illustrations for preparers, auditors and valuation specialists related to the issuance of privately-held company equity securities for compensation. It highlights practice issues related to estimating the fair value of a minority interest in a company's privately-issued securities.

The 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. The valuation of a company's capital structure begins with the determination of the fair value of the business enterprise.

The approaches used to value closely-held securities are the market, income and asset approaches. All three approaches should be considered, along with the facts and circumstances attendant to a particular valuation engagement, to determine which approach is most appropriate. If multiple approaches are used, the results should be analyzed to determine the reasonableness of the value produced by each approach.

The primary considerations when determining the appropriate valuation approach in this context include:

- 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.

An entity's stage of development is an important consideration in the determination of the appropriate valuation approach since the entity's value can be expected to change as it moves from one stage to another. For example, the market or income approach may be impractical for an early-stage entity given the lack of both market data for similar businesses and financial forecasts. The asset approach, generally considered the conceptually-weakest approach for valuing a business, may be the only approach available for an early-stage entity. As a business matures, the income and market approaches will become more appropriate. The backsolve method, which will be described herein, may be relevant at any stage of development if transactions occur close to the valuation date and at arm's length.

Market Approach

The theory of the market approach to the valuation of any asset, including privately-held securities, is the economic principle of substitution. An investor would not pay more than one would have to pay for an equally-desirable alternative. As such, it is broadly accepted within the business valuation community that the market approach is a valid approach to value privately-held securities because it uses observable factual evidence of actual sales of other properties to derive indications of value.

While no two companies are identical, proponents of the market approach advocate the identification of companies that are sufficiently similar to the subject company to provide users with "guideline" indicators of value.

The Ins and Outs of Non-Cash Compensation

Under the market approach, three generally-accepted methods are utilized for the determination of value:

- Guideline company transaction method,
- Guideline publicly-traded company method, and
- Subject company historical transaction method/backsolve method.

Guideline Company Transaction Method

The guideline company transaction method (also commonly referred to as the mergers and acquisitions method) relies upon information published in various databases in which certain details are set forth relating to the actual historical merger, acquisition and disposition transactions of entire companies, divisions or large blocks of both publicly-held and/or privately-owned capital stock. Conceptually, the theory behind the methodology holds that if sufficient financial information and data are available to draw a reasonable inference of comparability between the historical company transaction recorded in the database to the subject company under valuation, there may exist the possibility of extrapolating the database pricing/valuation information to the variables of the subject company, thereby providing a third-party indication of value. The primary requisite consideration to use the method properly is sufficient comparability.

Guideline Publicly-Traded Company Method

The guideline publicly-traded company method provides an alternative method to the guideline company transaction method under the market approach. It is generally held that if guideline publicly-traded companies can be identified, then measures of the fair market value of a subject company can be estimated through the use of market multiples developed from the guideline data. These multiples would be adjusted to reflect differences between the guideline companies and the target company with respect to growth, profitability, size and other relevant factors. The multiples are then used to estimate the value of the target company.

Publicly-traded companies are those whose securities are traded on any of the major public stock exchanges, including:

- New York Stock Exchange (NYSE), and
- National Association of Securities Dealers Automated Quotation System (NASDAQ).

Under the guideline public company method, the value multiples selected by the valuator for application to the subject company under valuation are developed from the identification and analysis of companies that are traded freely on an open stock exchange in the public markets.

The Ins and Outs of Non-Cash Compensation

First, the sheer number of publicly-traded companies offers the valuator an opportunity to draw comparable guideline companies from a broad pool of potential candidates. Second, the guideline public companies offer a sizable amount of quality financial, industry and economic data by which to determine the degree of comparability. The financial reporting requirements mandated by the SEC, as well as the severe scrutiny applied to publicly-traded companies by investment analysts and other interested parties, serve to ensure that the affected companies present a great deal of information to ensure compliance. Properly applied, this information allows for more direct analysis, better selected comparables and, ultimately, a better valuation conclusion.

Finally, the guideline publicly-traded company method incorporates, by its mechanics, observations of actively-traded stocks that are price-driven by independent third-party investors. The risk-versus-return considerations contemplated by these investors, in effect, mirror those that would be considered by a hypothetical buyer or seller of the subject company under valuation. Thus, use of this method correlates value to market-investor expectations.

It is noteworthy that many of these registered and reporting companies represent smaller and mid-size businesses, thus expanding the use of this method from only large companies in the past to smaller and mid-size privately-held businesses in today's valuation environment.

<u>Subject Company Historical Transaction Method/Backsolve Method</u>

Consistent with the guidance in FASB ASC Topic 820, *Fair Value Measurement,* more reliance should be placed on observable inputs than on unobservable inputs. By definition, securities in privately-held entities are not traded publicly. There may, however, be arm's-length cash transactions with unrelated parties that can be used as a proxy to estimate the value of the securities. Company management should consider the differences in rights and preferences between the securities in the observed transaction and the securities being valued.

The Guide introduces the backsolve method. In many early-stage entities, true comparables might not exist. As a result, it could be difficult to apply the guideline publicly-trade company method or the guideline company transactions method. However, it still might be possible to use another form of the market approach, the backsolve method. This method derives the implied value for the company and its securities from a recent arm's-length transaction involving the company's securities. Assumptions are made about the expected time to liquidity, volatility and risk-free rate, such that the price paid for the securities can be used to determine the value of the company and its other securities using option-pricing methodologies. The valuation analyst should also consider changes in the value of the company between the transaction date and the valuation date.

<u>Other Methods</u>

The Guide notes that using rules of thumb, including percentage of preferred stock sales price or discount to anticipated IPO price, is not appropriate when determining the fair value of minority interests in common stock.

The Ins and Outs of Non-Cash Compensation

Income Approach

A widely-held precept within the business valuation community is that all value is forward-looking. From this precept, it is further held that "the value of a business or an interest in a business depends on the future benefits that will accrue to it, with the value of those future economic benefits discounted back to a present value at some appropriate discount rate."[2] Said another way, "value today always equals future cash flow discounted at the opportunity cost of capital."[3]

The income approach is the approach within business valuation theory and development procedure that is most directly able to capture these fundamental precepts and incorporate them into the determination of business value or the value of an invested capital interest in a business at any specific date of valuation.

<u>Methodologies</u>

Within each of the three broad valuation approaches (market, income and asset-based), there are various "commonly-accepted" methodologies for the practical determination of value. Under the income approach, the two primary methods are the ***discounted future economic benefits method*** and the ***capitalization of future economic benefits method.***

In an effort to calculate the enterprise value of a company, the cash flow for all invested capital (both debt and equity) must be developed. Invested capital cash flow is defined as the cash flows available to pay out to equity holders (in the form of dividends) and debt investors (in the form of principal and interest) after funding operations of the business enterprise and making necessary capital investments.

The fundamental difference between the two available methodologies under the income approach is primarily mechanical. In effect, the capitalization (of future net cash flows) method "is simply an abridged version of the discounted [future net cash flows] method."[4]

Under the discounted future net cash flows method, all future-year expected net cash flows, forecasted over a discrete period, are discounted to their respective present values at an appropriate discount rate. In contrast to this methodology, the capitalization of future net cash flows method converts only a single future net cash flow number to an indicated present value at the date of valuation.

An important economic and mechanical distinction between the two methodologies is that the expected long-term sustainable growth of the anticipated future net cash flows is set forth in the net cash flows themselves,

[2] Shannon P. Pratt, Alina V. Niculita, <u>Valuing a Business, The Analysis and Appraisal of Closely-Held Companies</u>, 5th Edition, New York: McGraw-Hill.

[3] Richard A. Brealy and Stewart C. Myers, <u>Principles of Corporate Finance</u> , 7th Ed.,(New York: McGraw-Hill Inc., 2003.

[4] Shannon P. Pratt, Alina V. Niculita, <u>Valuing a Business, The Analysis and Appraisal of Closely-Held Companies</u>,5th Edition, New York: McGraw-Hill.

The Ins and Outs of Non-Cash Compensation

by period, in the discounted future net cash flows method. Under the capitalization of future net cash flows method, the long-term sustainable growth of the expected net cash flows is set forth in the capitalization rate, as opposed to the net cash flows themselves.

Due to this anomaly, the discounted future net cash flows method is most-often used when the valuation subject is expected to encounter varying growth levels over a discrete projection/forecast period. Alternatively, where it is deemed likely that the growth levels of the net cash flows will follow an even and consistent pattern in the future, business valuation theory generally calls for use of the capitalization of future net cash flows method. Most often, the capitalization of future cash flows method is used to value smaller companies with limited financial resources and limited capability to predict expected future net cash flows.

In applying the discounted future net cash flows model, once the future cash flows have been determined, a terminal value computation is required to account for company value attributable to the expected cash flows beyond the discrete projection/forecast period. In early-stage company valuations, the terminal value might comprise more than 100% of the value, as there could be cash flow losses in the earlier years. Forecasted net cash flows represent a significant input into the discounted cash flow model and should be estimated carefully by management. In the early stages of a company, it may be difficult to estimate future cash flows.

Discount Rate

The discount rate should consider both the systematic risk of the investment and the risk associated with meeting the particular cash flow projections if the latter is not already considered in the cash flow.

The most-appropriate discount rate to apply to cash flow for all invested capital using a discounted future net cash flows method is the weighted average cost of capital (WACC). The WACC is defined in *Valuation, Measuring and Managing the Value of Companies*, as "the opportunity cost that investors face for investing their funds in one particular business instead of others with similar risk."[5]

The WACC is implicitly tied to the subject company's capital structure, including debt capital. As such, "the most important principle underlying successful implementation of the cost of capital is consistency between the components of the WACC and the net cash flows."[6]

Since the net cash flows used in an invested capital model anticipate the cash flow available to the holders of all classes and types of capital, including debt capital, it is critical that the WACC include the required rate

[5] Tim Koller, Marc Goedhart, David Wessels, McKinsey & Company, Valuation, Measuring and Managing the Value of Companies, John Wiley and Sons, Inc., 2010.

[6] Ibid.

The Ins and Outs of Non-Cash Compensation

of return for each of the types of investors. To meet these consistency requirements, the cost of capital must meet the following criteria:[7]

- It must include the opportunity cost of all investors – debt, equity, and so on – since [net] free cash flow is available to all investors, who expect compensation for the [investment] risks they take;
- It [the WACC] must weight each security's required return by its target market-based weight, not by its historical book value; and
- Any financing-related benefits or costs, such as interest tax shields [deductions] not included in free cash flows.

In connection with the valuation of start-up or development-stage companies, Appendix B of the Guide provides venture-capital rates of return from a variety of sources. This appendix references rates of return data and studies performed by James Plummer (*QED Report on Venture Capital Financial Analysis*, 1987) and Daniel Scherlis and William Sahlman (*Method for Valuing High-Risk, Long Term, Investments: The Venture Capital Method*, Harvard Business School Teaching Note 9-288-006, Boston: Harvard Business School Publishing, 1989). Rates from the various studies are displayed below:

Stage of Development	*Rates of Return*
Startup	50%-100%
First Stage/Early Development	40%-60%
Second Stage/Expansion	30%-50%
Bridge/IPO	20%-35%

The appropriate discount rate is applied to the cash flow for all invested capital to determine the enterprise value of the company.

Asset Approach

The asset approach to business valuation encompasses a determination of value predicated upon an assessment of each of the subject company's assets – tangible and intangible, recorded and unrecorded – on its historical financial statements. Somewhat of a misnomer by name, the asset approach also requires a determination of the value of each of the subject company's liabilities, recorded and unrecorded, on its historical financial statements.

As a result of valuing each asset and/or liability, the historical balance sheet prepared under GAAP is converted to an economic balance sheet – one that reflects those assets and liabilities on a fair market value (or some other applicable standard of value) basis.

[7] Ibid.

The Ins and Outs of Non-Cash Compensation

Subtracting the economic balance sheet liabilities from the economic balance sheet assets yields the economic value of the equity of the company.

Often, the asset approach is referred to as the "cost/asset approach." The word "cost" in this title references the users of the approach to consider the original historical cost of the applicable assets. If appropriate, that cost will be adjusted forward through the date of valuation for inflation and other influences on cost, less an adjustment for wear and tear as well as for obsolescence.

The fundamental precept behind the asset approach is that an astute investor would not pay more for a collection of assets, net of liabilities, than the price for which the same assets could be purchased or constructed. The asset approach is typically only used in the earlier stages of a business, before intangible assets and goodwill have significant value.

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. In a simple capital structure with only debt and common equity, 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.

It is important to note that the fair value of debt can be different from its book value. A fair value of debt that is higher than the book value of debt indicates that interest rates have fallen or that the credit-worthiness of the company has increased. A fair value of debt that is lower than the book value of debt could indicate a period of rising interest rates or a decreasing credit rating for the company.

Value determinations for complex capital structures would be ascribed to the various classes of equity, which requires an understanding of the economic and control rights associated with each class. 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

The methods used to allocate fair value to the classes of equity are the probability weighted expected return method (PWERM), the option-pricing method (OPM), the current-value method (CVM) and the hybrid method. The facts and circumstances of each project will dictate the appropriate methodology applied. The Guide notes that the allocation should be performed using methods that (i) reflect the going-concern status of the company, (ii) assign some value to common shares, (iii) produce results that can be replicated or approximated and (iv) have a complexity appropriate to the security being valued. The methods are summarized below.

PWERM

The PWERM explicitly considers the economic rights of each share class and computes its value under different scenarios. The model uses estimates of different possible future outcomes available to the company (including IPO, merger or sale) to compute the value of the equity securities under these different scenarios. The values computed for the equity securities should be adjusted (if appropriate) for discounts, such as for illiquidity.

The values are discounted to present value and multiplied by a percentage that represents the probability of each scenario occurring. The PWERM is frequently used when the company is close to an exit event and different exit-event values may be estimated with greater reliability. When the time to an exit event is more uncertain, it can be difficult to develop reliable detailed assumptions about possible future outcomes.

OPM

The OPM treats a company's securities as call options on the company's value. This method explicitly recognizes and models the payoffs of the various share classes that resemble option-like payoffs.

The exercise prices of the securities are based upon the principal and coupons of debt as well as the liquidation preferences and dividends of preferred stock. The common stock is modeled as the right to receive the value of the company above the amounts that must be paid to debt and preferred equity.

The OPM assumes a future liquidation scenario and considers the rights and preferences of each class of securities. Depending upon the option model used by the valuation analyst, 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, the primary model for estimating future outcomes under the OPM, are described in detail below:

- ***Equity Value*** – Once the likely form of the liquidation event is assessed, the asset, market or income approach can be used to determine the current enterprise value of the company. The 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 a "breakpoint."

The Ins and Outs of Non-Cash Compensation

- ***Volatility*** – For a privately-held company, there is typically no data available by which to compute the volatility of equity. The volatility factor can be determined by using publicly-traded guideline companies. However, since the resulting value of equity in the model is sensitive to this factor, it is critical that the valuation analyst carefully consider the population of publicly-traded company stock prices and how the subject company relates to the population.

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

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

The OPM calculations can be computed on the equity or on the company's total capitalization. When using the total capitalization, debt needs to be considered as one of the breakpoints in the option analysis. The volatility assumptions need to be consistent with the equity or total capitalization assumptions.

ASC 718 provides extensive guidance for companies regarding selecting OPM inputs. The FASB states that estimates should be reasonable, supportable and determined in a consistent manner from period-to-period. The FASB guidance is summarized in the following table:[8]

Current stock price:	• Market value of underlying stock at measurement date (grant date for equity awards, and end of each reporting period until settlement for liability awards)
Exercise price of option:	• At-the-money, premium, or discount exercise price inputs (for indexed exercise prices, refer to *Compensation Cost for Other Design Features* below)
Expected term of option:	• Based on contractual term, vesting period (expected term must at least include the vesting period), expected early exercise and post-vesting employment termination behavior, expected volatility, black-out periods, and employee age, length of service, and location demographics; expected term is a direct input in a closed-form model, and is inferred based on the output of a lattice model • The SEC staff in Section 718-10-S99 provides additional guidance for companies when estimating an option's expected term. In general, companies are not allowed to consider additional term reductions for nonhedgability, nontransferability, or forfeitures, and the option term cannot be shorter than the vesting period. Companies are permitted to use historical stock option exercise experience to estimate expected term (with as few as one or two relatively homogenous employee groupings) if it represents the best estimate of future exercise patterns. Section 718-10-S99 provides a simplified method to estimate expected term for "plain vanilla" stock options (as defined by Section 718-10-S99) that is calculated as the vesting period plus the original contractual option term divided by two. The SEC staff in Section 718-10-S99 provides that the SEC will continue to accept use of the simplified method on an interim basis, provided a company concludes that its own historical option exercise experience does not provide a reasonable basis for estimating expected term

[8] Frederic W. Cook & Co., Inc., *Accounting for Stock Compensation Under FASB ASC Topic 718*, September 2, 2009.

The Ins and Outs of Non-Cash Compensation

Risk-free interest rate(s):	• Implied yield(s) on U.S. Treasury zero-coupon issues, using yield curve over contractual option term for lattice models and current yield with remaining term equal to expected option term for closed-form models (special guidance is provided for jurisdictions outside the U.S.)
Expected stock price volatility:	• Generally based on historical price observations commensurate with contractual term for lattice models or expected term for closed-form models, as adjusted for supportable future expectations; other factors to consider in estimating volatility include, "mean reversion" tendencies, "implied" volatility of traded options or convertible debt (if any), "term structure" of expected volatility (if using a lattice model), and expected volatility of similar companies (for newly public or nonpublic companies) • Nonpublic companies may use the historical volatility of an appropriate industry index in certain situations (refer to *Compensation Cost for Nonpublic Companies* below) • The SEC staff in Section 718-10-S99 provides extensive guidance on how companies should estimate expected volatility, particularly in regard to historical and implied volatility. In general, historical volatility should be measured on an unweighted basis over a period equal to or longer than the expected option term for closed-form models or contractual option term for lattice models based on daily, weekly, or monthly stock price observations. Future events should be considered to the extent other marketplace participants would likely consider them, and prior periods may be excluded in rare circumstances. Implied volatility is based on the market prices of a company's traded options or other financial instruments with option-like features, and can be derived by entering the market price of the traded option into a closed-form model and solving for the volatility input. The SEC staff believes that companies with actively traded options or similar financial instruments generally should consider implied volatility, and even place greater or exclusive reliance on it, taking into consideration (1) volume of market activity, (2) synchronization of variables, and (3) similarity of exercise prices and option terms. Section 718-10-S99 also provides guidance for companies that wish to place exclusive reliance on either historical or implied volatility, and for newly public companies. Appropriate disclosure of the method used to estimate expected volatility should be made in the Management's Discussion and Analysis (MD&A) section of public filings
Expected dividends on stock:	• May be input as either an expected yield or dollar amount, taking into account supportable future expectations based on publicly available information (no single method of estimating fair value is specified for dividend-paying stock options and SARs)

A criticism of the OPM is that the Black-Scholes model assumes a lognormal range of future possible outcomes. Some early-stage companies may not have the smooth distribution of outcomes that is predicted by the Black-Scholes model. Please note, to address this criticism in any detail or technical respect is beyond the scope of this presentation.

CVM

The CVM first calculates the value of the company's equity on a control basis (assuming a sale of the company) and, then, allocates that value to the various series of preferred stock based upon liquidation preferences and/or conversion ratios. Any remainder is allocated to the common equity.

The primary advantage of the CVM is that it is easy to apply and understand. The primary disadvantage is that the value that is allocated to the common equity does not consider the option-like nature of com-

The Ins and Outs of Non-Cash Compensation

mon stock; thus, the method does not consider possible changes in the value of the company. As a result of this disadvantage, it is recommended that the CVM be used only when a liquidity event is imminent, which minimizes changes in time and changes in the value of the company, or when the company is at such an early stage of development that no material progress has been made on its business plans; thus, no value beyond liquidation preferences could be expected at such time.

Hybrid Method

The hybrid method takes the scenarios found in a PWERM and uses an option-pricing methodology on each scenario. This method is typically applied when there is a significant uncertain event that could materially affect the value of the company. As a result of this single uncertain event, the range of future possible outcomes might no longer be represented by a lognormal distribution, which is the assumption underlying the OPM.

A main advantage of the hybrid method is that it applies the conceptual framework of the OPM to different scenarios, while a disadvantage is that the model can become complex and require a significant number of assumptions.

Adjustments for Control and Marketability (or Lack Thereof)

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. The security under valuation may have specific limitations, and these limitations may result in the consideration of certain adjustments for lack of control, liquidity and marketability as well as voting rights.

In computing discounts for lack of marketability, certain factors must be considered, including the estimated time to liquidity (for the securities or the entire company), restrictions on the transferability of the securities, pool of potential buyers, risk or volatility, size and timing of distributions and concentration of ownership.

Please note that it might be appropriate to apply an additional discount for lack of marketability to the junior securities, as the junior securities could be less marketable than more-senior securities.

The methods used to derive the discounts are beyond the scope of these materials.

The Ins and Outs of Non-Cash Compensation

Practical Examples

Presented on the following pages are examples of two equity allocation methods: the PWERM and the OPM. Please note that the examples are simplified and intended for presentation purposes only. The assumptions used in preparing the examples are as follows:

- In both examples, ABC Company has two classes of stock: common stock (8,000 shares) and convertible preferred stock (2,000 shares), representing a total of 10,000 shares outstanding. In addition, a liquidity event is expected to occur in five years' time.

- In the application of the PWERM, four liquidity events (and the likelihood of each event occurring) 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; and
  - A dissolution of the company – 5.0% likelihood.

- In the application of the OPM, the following assumptions are utilized:
  - A company equity value of $5.0 million, which was determined by using a discounted cash flow method under the income approach;
  - A liquidity event will occur in five years' time;
  - A risk-free rate of 1.46%; and
  - Volatility of 60.0%.
  - In addition, it is assumed that a discount for lack of marketability of 20.0% will be applied to the per-share value of the common stock on a marketable basis.

Allocation Method: Probability Weighted Expected Return Method

(in $000, except for the number of shares and per-share amounts)

Security	Issued	Shares	Share	Value	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**
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**

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		**Breakpoint**	**1**	**2**	**3**
Security	**Number of Shares**		**$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%

		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**

The Ins and Outs of Non-Cash Compensation

Conclusion

The valuation of equity-based compensation can be very complex. The valuation analyst should be qualified to perform the valuation due to the many factors that must be considered as well as the complexity of the models applied. Proper understanding of the purpose of the valuation assignment and the rights and restrictions of the securities is critical.

Legal counsel can consult with valuation analysts prior to implementing a plan for their clients to properly understand how the equity instrument is valued and the effect that it can have on the company.

The Ins and Outs of Non-Cash Compensation

VI. Conclusion and Practical Considerations

Adding non-cash equity-based consideration to the complement of offerings in a company's compensation structure can yield significant benefits, as noted throughout these materials. Perhaps the most important of these is the use of equity-based consideration to enhance employee retention and to align personal goals of the employees receiving that compensation with those of the company. There is no other means quite like equity to accomplish this goal.

Further, the addition of equity-based consideration to an employment offer can serve to fill gaps where cash is simply not available to compensate "critical need" employees. Such is often the case in the start-up phases of technology companies, but is not limited solely to that industry. Finally, offering equity-based compensation can allow for differentiation in employment offers, thereby, separating the company from the pack and enhancing recruitment results.

The challenges and concerns differ, depending on whether the employer company is publicly- or privately-owned. The primary difference is, of course, the degree of marketability associated with each, which is dependent upon the presence in the public sector of a ready market to handle value and liquidity concerns.

The primary concerns for the private company employer/business owner (i.e., the principal security holder) are related to the severance of control and having to report and account to minority shareholders in managing the business. However, there are various means by which to provide long-term equity incentives to employees without ceding control to them.

Several practical issues arise in connection with issuing equity to employees, including: (i) diluting current owners, which could reduce their control over management of the company; (ii) ensuring that the equity is not transferred to third parties who are not affiliated with the company or may not share the same views on the direction of the company; (iii) valuing a security that is not publicly-traded; and (iv) funding the company's repurchase of shares. These matters are discussed in more detail below.

Since the company will likely be providing only minority interests, the probability that this will take away control is minimal or nil. Nevertheless, minority security holders can create problems and disturbances that can become a distraction. Accordingly, resale provisions that would be triggered upon departure of an employee should be put in place.

Also, a nonvoting equity interest, such as a Class B nonvoting interest can be issued. The lack of voting rights obviously mitigates any concerns about control. Alternatively, stock appreciation rights that are settled in cash can be awarded, which provide no rights to management but, merely, the right to cash, based on the appreciation in the value of the company, as discussed earlier.

The company will want to protect the audience for its equity ownership. Thus, the company will not want employees to transfer their equity to unrelated third parties. Accordingly, each employee should be required to enter into certain agreements with buy-sell provisions that will require them to sell their equity back to the company under certain circumstances and trigger events. These circumstances include termination of employment, sale of the company by the majority security holder (i.e., drag-along rights), insolvency of the employee, etc. These transfer restrictions are also important to ensure compliance with securities laws.

Without a public marketplace, a privately-held company also needs to determine its fair-market value in order to issue equity and/or make repurchases. There are various means of doing this, including periodic (e.g., annual) determination by a valuation expert, book value and a formula based on a multiple of revenues or net income. The method chosen will depend on the industry, the preferences of the security holders and the amount of time and money they wish to spend.

An ongoing problem for many privately-held companies is how best to fund equity repurchases. This can be handled in many ways, including making payments over time above certain dollar amounts, using certain insurance vehicles if the repurchase occurs in connection with the death or disability of the security holder, or placing contractual limits on the dollar amount of repurchases that can be made in any year (absolute amount or percentage of annual revenues or net income). The company may also consider a line of credit to assist during seasonal periods when working capital may be low. In addition, where reasonable, the company may set up a "sinking fund" to pre-fund the repurchase.

Given these considerations and the processes and technical matters discussed throughout today's program, the question arises as to whether the use of such non-cash equity-based compensation is a practical means of attaining strategic goals. The authors would note that such a determination is sensitive to the specific facts and circumstances, and that each case requires a stand-alone evaluation. However, suffice to say, that employee ownership is a growing phenomenon, and more employees, especially in management, are asking about the opportunity to acquire equity.

The structure of the equity incentive plan is set by legal counsel, and though we work closely with the attorney community in developing plan structures, it is the plan document that must be carefully crafted to ensure that the employer/company goals and desires are captured properly.

The Ins and Outs of Non-Cash Compensation

It is reasonable to consider the following items (not all-inclusive) in drafting the plan document:

- The types of awards that will be available for issuance under the plan.
- The appropriate share reserve.
- The appropriate vesting schedule for awards granted under the plan.
- The methods participants can use to pay the exercise price of stock options.
- The permissible methods for satisfying tax withholding obligations.
- The definition of change in control to be included in the plan and what will happen to outstanding awards on a change in control.
- The types of restrictions that will be placed on the transfer of shares.
- How (and where) liquidity considerations will be addressed.
- Whether the plan will contemplate clawbacks and forfeitures.
- For companies considering an initial public offering (IPO), whether a public company styled plan should be adopted.

Finally, other items that should be considered are the following rights granted by other corporate or organization documents, principally shareholder and equity owner agreements:

- ***Drag Along Rights*** – These rights give the majority shareholder the power to force minority shareholders (in this case, possibly a participant in the equity-based compensation plan) to join, on a pro rata basis, in a sale of the company at the same price, terms and conditions that the majority shareholder receives. Drag along rights are important for the majority shareholder to be able to deliver 100% of the company on a sale without any dissenting vote from minority shareholders.

- ***Tag Along/Co-sale Rights*** – These rights provide the minority shareholder (equity-based compensation plan participant) the right to sell the same portion of his/her shares, at the same price and on the same terms and conditions that the majority shareholder receives, when the majority shareholder sells all or a portion of its shares.

- ***Rights of First Refusal*** – These give the company the right to purchase any shares held by the participant before a sale of the shares to a third party, at the same price and on the same terms and conditions as were offered to the third-party purchaser. The participant may only sell to the third party if the company declines to purchase the shares. A participant's rights to sell to a third party always remains subject to the other provisions of the shareholders' agreement (including any then-applicable transfer restrictions).

The Ins and Outs of Non-Cash Compensation

Again, the time allotted to today's presentation does not allow for a detailed discussion of all of the complexities and technical aspects of utilizing non-cash equity-based compensation plans. However, the authors hope that you are able to better understand the key considerations that should be given to such plans and the foundational matters related to the accounting, tax and valuation issues relating to the recommendation and implementation of these types of benefit plans for your clients and their employees.

Should you find that you have further questions or comments with respect to these materials and any information shared throughout today's presentation, please feel free to contact any of the presenters:

Bob Grossman	Melissa Bizyak	Steve Heere
Partner	Partner	Partner
412.338.9304	412.338.9313	412.338.9307
grossman@gyf.com	bizyak@gyf.com	heere@gyf.com

As always, we are greatly appreciative of the support that we have received and continue to receive from all of our friends and contacts in the legal community and we look forward to working with each of you. We are pleased that you could join us this morning and hope that you are able to take something beneficial away from today's program as you return to your practices.

Thank you again and have a great day!