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Valuing Your Company For Compensation

Presented by:

Claire Iacobucci, CPA– Director, Audit Services

Paul Oliveira, CPA, MST– Director, Tax Services

Bradford Taylor, ASA, AVA– Director, Business Valuations

Introduction and Overview

- **Cash versus equity compensation drivers**
  - Liquidity, retention, dilution
- **Equity compensation is not uncommon but is complicated**
  - Why is a valuation needed – tax perspective
  - How do you value early stage companies
  - Different types of equity used
  - Financial statement implications

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Why Do You Need a Business Valuation for Compensation Purposes?

- **Taxpayer who receives <u>property</u> in connection with the performance of services recognizes ordinary income.**
  - Recognition occurs either upon receipt, or if later, when vesting occurs.
  - Taxable amount is equal to the excess of the property's <u>fair market value</u> on the recognition date, if any, over any amount that the taxpayer may have paid for the property.

- **Tax reporting concerns will cause valuation issues to take center stage when some form of equity is offered as compensation.**

- **Tax treatment applies whether the service provider is classified as an employee or independent contractor.**

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Why Do You Need a Business Valuation for Compensation Purposes? (cont.)

- **IRC Section 409A was enacted in 2004 to attack abusive unfunded deferred compensation plans.**

- **Generally, compensation is taxable in the year actually or constructively received, whichever is earlier.**

- **IRC Section 409A established strict requirements for unfunded arrangements including:**
  - Strict timing requirements when deferral deductions can be made
  - Limited payment triggers for deferred compensation
  - Prohibition of accelerated payment of deferred compensation
  - Requirement of written documentation

- **IRC Section 409A also imposes harsh penalties for failure to comply** – 20% additional federal tax!

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Why Do You Need a Business Valuation for Compensation Purposes? (cont.)

- **A nonqualified stock option that is considered "in-the-money" when the option is granted constitutes IRC Section 409A deferred compensation.**
  - "In-the-money" means that the fair market value of the underlying shares exceeds the option exercise price on the date of grant.

- **Implications of IRC 409A**
  - A nonqualified stock option considered in the money is taxable for each year that it vests, based on the fair market value of the underlying stock at the end of the vesting year.
  - When considering a 20% penalty that applies under IRC Section 409A, the amount taxable could be subject to a top federal rate of as much as 55%.

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Why Do You Need a Business Valuation for Compensation Purposes? (cont.)

- **In order to avoid the taint of §409A on a nonqualified stock option grant, it is vital to establish the fair market value of the underlying stock on date of grant.**

- **For privately held companies, <u>fair market value means</u> "a value determined by the <u>reasonable</u> application of a <u>reasonable</u> valuation method."**

- **The regulations under IRC Section 409A provide three valuation approaches that are considered presumptively reasonable.**
  - An independent appraisal updated at least annually meeting the requirements for valuing employer stock held in an employer stock ownership plan (ESOP).
  - In more narrow circumstances, a formula value may be used.
  - A written valuation performed by "a person or persons that the corporation reasonably determined is qualified…"

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Business Valuation 101

- **Two main elements to any value:**
  - Future cash flows
  - Risk of generating cash flows

- **The value of business can differ in different circumstances**

Business Valuation 101

- **The are three main approaches to performing a business valuation:**
  - Asset/Cost Approach
  - Income Approach
    - Capitalization of Earnings
    - Discounted Cash Flow
  - Market Approach
    - Subject Company Transaction
    - Guideline Public Company Analysis
    - Comparable Transactions Analysis

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Valuing Early Stage Companies

- **Why are business valuations needed for start-ups or early stage companies?**
  - Founder's Stock (83(b) election)
  - Valuing technology transfers
  - Stock options (IRC 409A/ASC 718)
  - Sale

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Valuing Early Stage Companies

- **Asset/Cost Approach**
  - Typically, the asset approach method is not utilized.
    - Assets or usually intangible in nature
      - Technology, software, patents, assembled workforce.
  - Cost approach can be utilized to a certain degree
    - Value the monthly expenses of the business and grow those expenses by a return a venture capitalist/private equity investor would expect
    - This is a hybrid method with an income approach

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Valuing Early Stage Companies

- **Income Approach**
  - Capitalization of Earnings is rarely used.
    - History ≠ Future
  - Discounted Cash Flow
    - The preferred method to valuing early stage companies
    - What is needed?
      - A forecast – preferably five years or until a normal stage of growth is achieved
      - A discount rate based upon the risk of achieving those cash flows

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Valuing Early Stage Companies

Stage of Development	Plummer	Scherlis and Sahlman	Sahlman, Stevenson, and Bhide	Bygrave	HVA/ VentureOne
Start-up	50% - 70%	50% - 70%	50% - 100%	60% - 80%	100% - 125%
First stage or "early development"	40% - 60%	40% - 60%	40% - 60%	50%	60%
Second stage or "expansion"	30% - 50%	30% - 50%	30% - 40%	40%	50%
Third / Fourth Stage	30% - 40%	n.a.	n.a.	30%	40%
Bridge/IPO	25% - 35%	20% - 35%	20% - 30%	25%	30%

- **Source:** Working Draft - AICPA Practice Aid: Valuation of Privately-Held-Company Equity Securities Issued as Compensation: 2011

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Valuing Early Stage Companies

- **Market Approach**
  - Subject Company Transactions
    - Often used in 409A/ASC 718 valuations
      - Backsolve to most recent preferred investment round
  - Guideline Publicly Traded Companies
    - Not often used in valuing early stage companies as most companies have little if any revenues or earnings
      - Multiples of R&D
      - Multiples of operating expenses
  - Comparable Transactions Method
    - Not often used in valuing early stage companies as most companies have little if any revenues or earnings

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Valuing Early Stage Companies

- **IRC 409A / ASC 718**
  - Once the value of the total equity is derived, one needs to allocate that value across all of the equity claims
  - So how do we do that?
    - Three methods of allocation as determined in the AICPA Practice Aid: Valuation of Privately-Held-Company Equity Securities Issued as Compensation: 2004
      - Being updated now with Working Draft already released
        - http://www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/DownloadableDocuments/Cheap_Stock_Working_Draft.pdf

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Valuing Early Stage Companies

- **IRC 409A / ASC 718**
  - Safe Harbor Provisions – Valuation
    1. Valuation by a qualified appraiser
       a. Must be within 12 months
    2. Valuation based upon a formula
       a. Must maintain this formula for all transactions except sale of company
    3. Valuation by "qualified" person. Generally, this is someone within the company or an investor who has performed valuations
       a. Company must be under 10 years old
       b. No change of control or IPO within next 12 months

Valuing Early Stage Companies

- **Allocation Methodology**
  - Current Method
    - Traditional water fall method
  - Option Pricing Method
    - Treats common stock as a call option on the total equity value of the company with exercise prices based on the liquidation preferences of the preferred stock
  - Probability Weighted Expected Return Method (PWERM)
    - The value of the common stock is estimated based upon an analysis of future values for the enterprise assuming various future outcomes

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Different "Flavors" of Equity Compensation

- **Corporations**
  - Outright stock grant, without substantial risk of forfeiture.
  - Taxable in the year of grant to the extent fair market value of the stock exceeds the amount paid for it.
  - For employee, taxable amount is subject to payroll tax withholding and is reportable on Form W-2.
  - For independent contractors, taxable amount is reportable on Form 1099.
  - The employer is entitled to a compensation deduction in the fiscal year in which the employee or service provider recognizes income.

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Different "Flavors" of Equity Compensation (cont.)

- **Restricted stock grant, subject to a substantial risk of forfeiture.**
  - Taxation is generally delayed until the year that substantial risk of forfeiture lapses. Amount taxed is the excess of fair market value <u>on date risk of forfeiture lapse</u>s over the amount paid for the stock.
  - IRC Section 83(b) allows recipient to elect to recognize ordinary income to the extent fair market value of stock on <u>date of grant</u> exceeds the amount paid for the stock.
    - The election must be made within 30 days after receipt of the property and a copy attached to the recipient's return.
  - Any amount taxable is subject to same tax withholding and reporting rules as applicable to outright stock grant.
  - The employer is entitled to a compensation deduction in the fiscal year in which the employee or service provider recognizes income.

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Different "Flavors" of Equity Compensation (cont.)

- **Non-qualified stock option (not "in-the-money" on date of grant)**
  - Taxable to the extent fair market value of stock on date of exercise exceeds the exercise price paid for the stock.
  - For employees, taxable amount is subject to payroll tax and reportable as compensation on Form W-2.
  - For independent contractors, taxable amount is reportable on Form 1099.
  - The employer is entitled to a compensation deduction in the fiscal year in which the employee or service provider recognizes income.

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Different "Flavors" of Equity Compensation (cont.)

- **Incentive stock options (ISO):**
  - If the option qualifies an ISO, an <u>executive</u> does not recognize income for income tax or employment tax purposes, either on date of grant or date of exercise, provided that ISO holding period is satisfied. (Income recognized for alternative minimum tax purposes.)
  - The holding period is satisfied if the executive continues to own the shares received pursuant to the option exercise for the longer of two years after ISO grant and one year after ISO exercise.
  - If holding period is satisfied, executive enjoys capital gain treatment on ultimate disposition of stock.
  - If holding period is not satisfied, the disqualifying disposition generates ordinary compensation income for the lesser of (1) the spread at time of ISO exercise or (2) the amount of gain recognized upon the disqualifying disposition.
  - Income from disqualifying dispositions reportable on Form W-2.

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Different "Flavors" of Equity Compensation (cont.)

- **ISO Qualification Requirements:**

1. Company granting the option must be a corporation.
2. The option must be granted to an individual in connection with his employment by Company (or a subsidiary.)
3. The option must be granted within 10 years from the earlier of the date the stock option plan was adopted by Company board or approved by its shareholders.
4. The option cannot be exercised after 10 years from the date of grant (or such shorter period as is stated in the ISO grant).
5. The option price cannot be less than the fair market value of the stock at the time the option was granted.

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Different "Flavors" of Equity Compensation (cont.)

- **ISO Qualification Requirements:**

6. The option must be non-transferable (except at death).
7. The person to whom the option is granted cannot own more than 10% of Company (or a Company subsidiary's) voting stock at the time of grant (unless the optionee satisfies the Code §422(c)(6) rules).
8. The aggregate fair market value (determined at the time of grant) of stock for which any executive may be granted ISOs from Company and its affiliated corporations, that are first exercisable during any one calendar year, cannot exceed $100,000. To the extent this $100,000 rule is violated, only the excess options (i.e., stock FV above $100,000) are treated as Nonqualified stock options. This rule applies to ISOs which first became exercisable during the calendar year in the order granted.
9. The option plan must meet technical statutory requirements, including a requirement of timely shareholder approval.
10. The option must not state that it is not an ISO.

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Different "Flavors" of Equity Compensation (cont.)

- **Partnership/LLC Interests**
  - Profits Interest – A person granted a profits interest in exchange for providing services is generally not a taxable event. Person simply picks up income or loss allocable under the partnership/LLC agreement.
  - Capital Interest – A person granted a capital interest in exchange for providing services is generally taxable in the same manner as a grant of stock from a corporation.
  - Options to Purchase Capital Interests – Treated under the same principles that govern the issuance of nonqualified stock options in a corporation.

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Financial Statement Considerations

- **Concept of fair value in financial reporting**
  - Replacing historical cost in many areas
  - Stock issued for compensation is measured at fair value
  - Value exchanged - equity instruments for goods or services
- **FAS 123(R)** ***Share-Based Payment*** **(ASC 718) governs**
  - Employees, directors, and non-employees
  - Vesting may depend on person rendering service, attaining a performance target (revenue, bottom line, etc.) or market (underlying stock's performance)
    - Can be graded i.e. 20% annually over 5 years or cliff i.e. fully vest after 3 years

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Financial Statement Implications

- **Income statement expense recognition**
  - Equity awards are measured at grant date, generally not remeasured
  - Record expense for awards expected to vest (Dr. Expense / Cr. APIC)
    - Reassess each reporting period , true up once known
    - Typically determined using Black Scholes option-pricing model
  - Reversing expense
    - Reversed upon forfeiture or performance condition not met
    - Not reversed if vested award expires unexercised or is cancelled

Financial Statement Implications

- **Balance Sheet**
  - Issuing common stock impacts the balance sheet (Dr. Cash / Cr. Equity)
  - Issuing common stock <u>options</u> …
    - Essentially does not (Dr. Expense>Retained earnings / Cr. APIC)
    - Until option is exercised then shares are issued and outstanding

- **Need sufficient common stock shares authorized to allow for options granted to be exercised into shares issued**

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Financial Statement Implications

- **Notes to the financial statements**
  - Description of the share-based arrangement: general terms of awards, requisite service period and substantive conditions/ vesting, contractual term, shares authorized for awards and method chosen to measure compensation cost
  - Various disclosures typically shown in tabular form
    - Number and weighted-average exercise prices for shares outstanding, exercisable, granted, exercised, forfeited or expired during the year. Certain disclosures of nonvested awards.
    - Number and weighted-average grant-date fair value shares

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Financial Statement Implications

- **Notes to the financial statements (continued)**
  - Description of the significant assumptions used to estimate the fair value of awards, including:
    - Expected term/life, often vesting period in early stage companies
    - Expected volatility of the entity's shares during the contractual term and the method used to estimate it
    - Expected dividends, usually none
    - Expected risk-free rate of return – usually U.S. Treasury securities yield commensurate with the expected term

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Questions?

Thank you

Claire Iacobucci, CPA– Director, Audit Services

(ciacobucci@kahnlitwin.com)

Paul Oliveira, CPA, MST– Director, Tax Services

(poliveira@kahnlitwin.com)

Bradford Taylor, ASA, AVA- Director, Business Valuations

(btaylor@kahnlitwin.com)

www.KahnLitwin.com
Phone: 888-KLR-8557

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