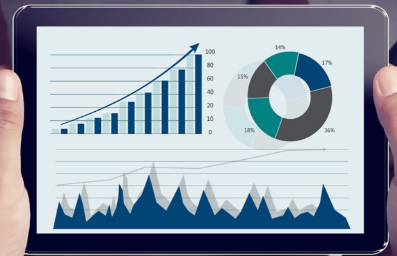
Equity compensation

Valuation Considerations for companies with complex capital structures



Valuation of various equity classes issued by an enterprise can be a daunting but necessary exercise for a private company when certain key milestones occur (e.g., exploring another round of financing or granting share-based compensation to employees) or for meeting tax and financial reporting requirements.

This document highlights common situations involving equity compensation that may require valuations. It also describes the methodologies most frequently used to value multiple equity classes when these situations arise.

When are valuations needed?

Valuations play a critical role in tax reporting, financial reporting, and in informing financing decisions. Below are some common examples where equity compensation valuations may come into play.

Tax compliance

A timely valuation of an enterprise's shares may be required for tax compliance if management plans to make share-based awards in the form of options or restricted stock. Two common examples include compliance with Section 409A and IRC 83(b).

Nonqualified deferred compensation plans

Section 409A of the Internal Revenue Code (IRC) calls for a holder of an in-the-money option (i.e., the fair market value (FMV) of the underlying share exceeds the exercise price) at the grant date to recognize taxable income equal to the difference between the FMV of the shares and the exercise price as they vest. The applicable combined federal and state tax rate upon vesting may be as high as 85 percent or more in some cases. Therefore, it is particularly important for companies to accurately determine the FMV of the shares on the grant date to minimize tax surprises.

IRC 83(b)

A recipient of equity compensation that is subject to vesting requirements may elect to be taxed on the grant date value of the shares rather than the value of the shares on future vesting dates. This election may be advantageous if it is believed the FMV of the shares will be higher on the future vesting dates than on the grant date. If this election is made, notice must be provided to the IRS within 30 days of the grant date. The FMV of the shares must then be determined on the grant date to determine the recipient's tax obligation.[1]

Financial reporting

Valuations of share-based awards are often required to establish compensation expense (in the case of grants to employees under *Accounting Standards Codification (ASC) Topic 718, Compensation—Stock Compensation)* or to account for distributions to shareholders under *ASC Topic 505, Accounting for Distributions to Shareholders with Components of Stock and Cash.*

In addition, in certain situations, warrants are required to be valued separately from the instruments to which they were attached in accordance with *ASC Topic 815, Derivatives and Hedging and ASC Topic 820, Fair Value Measurement.*

Financing decisions

Valuations can also be helpful to understand the value exchanged or potential dilution associated with issuances of subordinated securities—either to motivate employees with equity compensation or to attract new equity investors or debt financing.

[1] Certain additional considerations may arise when valuing partnership interests for tax purposes.

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Valuation challenges

The calculation of common equity share price can be rather straightforward for companies with simple capital structures (i.e., comprised of only one class of equity). However, this can be a challenge for companies with complex capital structures since total equity can't simply be divided by the number of shares outstanding to derive the share price.

Not surprisingly, complex capital structure requires more complex allocation methodologies. The most common of these approaches include the option pricing method and the probability-weighted expected return method. In addition, the current value method may be applied in certain specific circumstances.

Option pricing method (OPM)

This allocation methodology treats common stock and preferred stock as call options on the enterprise's equity value, basing exercise prices on the liquidation preferences of the preferred stock. Common stock has value only if the funds available for distribution to shareholders exceed the value of the liquidation preferences at the time of a liquidity event such as a merger or sale. The common stock is modeled as a call option that gives its owner the right, but not the obligation, to buy the underlying equity value at a predetermined or exercise price.

The OPM is typically applied when future liquidation events are difficult to forecast.

Probability-weighted expected return method

This allocation methodology, often referred to as the PWERM, estimates the value of the various equity securities through an analysis of future values for the enterprise, assuming various future outcomes. Share value is based upon the probability-weighted present value of expected future investment returns, which considers each of the possible future outcomes available to the enterprise as well as the rights of each share class. Although the future outcomes in any given valuation model will vary based upon the enterprise's facts and circumstances, common future outcomes modeled might include an IPO, a merger or sale, a dissolution, or continued operation as a private enterprise. This method involves a forward-looking analysis of the potential future outcomes; it also estimates the ranges of future and present value under each outcome and applies a probability factor to each outcome as of the valuation date.

The PWERM is typically applied when future liquidation events can be reasonably estimated but are not imminent.

Current value method

This allocation methodology is based on an estimate of equity value on a controlling basis assuming an immediate sale or liquidation of the enterprise. Once that estimate is established, specialists allocate value to the various series of preferred stock based on those series' liquidation preferences or conversion values, whichever would be greater.

This approach works well when an enterprise is at an early stage of development or when a liquidity event is imminent. It is rarely used outside of these specific situations.

Have questions?

For more information, please contact your local KPMG adviser.

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