

## **Getting a Grip on Stock Options**

*New Rules Require Companies to Obtain Stock Valuations*

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Business owners or principals in private companies need to be aware of federal tax code and financial accounting standards changes regarding the use of stock options and the importance of business valuations.

Now more than ever it has become important to know the fair market value of the stock of a private company at the time of the employee award of stock or options. *Failing to understand* the methods and associated provisions of key IRS and FASB changes can result in significant penalties and other financial liabilities for your business.

### **IRS Section 409A and FASB 123(R)**

The Internal Revenue Service has issued proposed regulations for IRC 409A relating to Non-Qualifying Deferred Compensation, which has come to be interpreted as including stock options and stock appreciation rights (SARS). Under the new IRS code, stock options that are granted at less than the option's fair value; i.e. "discounted options", can have adverse tax consequences to option recipients as the options vest, including a 20% additional tax in addition to regular income and employment taxes, and a potential interest charge. 409A also imposes tax withholding responsibilities on the granting company. Additionally, the new regulations can impact previously granted options that were granted or vested after certain "grandfather" dates. The proposed regulations are expected to be finalized during 2006, with an expected effective date of January 1, 2007; however, interim guidance has been issued as how to comply with the fair market value requirement needed to avoid 409A treatment until the proposed regulations have been finalized.

The Financial Accounting Standards Board (FASB) has issued Statement 123(R) for purposes of complying with Generally Accepted Accounting Principles (GAAP). This statement requires companies to calculate and include in financial statements estimated compensation expense associated with share-based compensation arrangements.

Together, these two new rules place increased pressure on management to determine the valuation of their companies and, in turn, the stock options granted to employees. For publicly-traded companies this valuation is easier as it is based on the traded value on the day the options were issued. The valuation task for private companies is more difficult as a valuation analysis must be performed that incorporates accepted standards of fair value in order to best estimate the company's fair market value.

### **Determining Fair Market Value**

The initial step in determining the Fair Market Value of a stock option is to determine the fair value of the underlying stock that can be purchased. To determine the Fair Market Value of the stock, you must establish the value of the entire company. Although

all of the following valuation methodologies must be considered, the value will likely be based on one of several approaches:

- The asset approach, which may be appropriate only for very early stage development companies;
- The income approach, most likely using a discounted cash flow analysis requiring management projections; and,
- The market approach, which would consider the latest round of financing, guideline public companies, and recent M&A transactions.

To appropriately determine the approach which best estimates the fair market value of a company often requires a seasoned valuation expert.

### **What Does This All Mean To Business Owners?**

From the perspective of Chris Ozburn, Partner with the law firm of Wilson Sonsini Goodrich & Rosati PC, “We are recommending for clients to proactively address these elevated valuation requirements. That way, they can be confident that the valuation they are using for setting option exercise prices considers all of the appropriate factors, plus they will have addressed IRS and accounting regulators’ concerns.”

For those that care to heed this perspective, here are some actions you may consider to ensure that you avoid any costly mistakes or penalties.

First, understand the types of deferred compensation agreements you have with employees, contractors, board members, advisors, and investors that should be considered within the realm of calculating tax and accounting compensation.

Secondly, evaluate your current method of valuing your company’s stock when issuing stock options or other types of deferred compensation – will your method of valuing your stock stand up to the scrutiny of 409A and satisfy your auditor’s requirements for 123(R)? At some point you might want to consider consulting with a valuation specialist about preparing a valuation report based on the increased requirements of 409A and 123(R).

In summary, requirements around granting stock options continue to become more complicated as the various regulatory bodies increase the scrutiny. But, some careful planning with your internal team and your outside legal, tax, and accounting advisors can help you ensure that you retain stock and options as the powerful tool they can be in attracting the best talent.

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