HEMMING MORSE, LLP

CERTIFIED PUBLIC ACCOUNTANTS,
FORENSIC AND FINANCIAL CONSULTANTS

Stock Options for Private Companies: Understanding the Risks, Realizing the Rewards

HEMMING MORSE, LLP

CERTIFIED PUBLIC ACCOUNTANTS,
FORENSIC AND FINANCIAL CONSULTANTS

Executive Brief

• Stock options have been useful components of employee compensation, but new accounting rules adopted in 2005 can have a significant impact on a company's financial processes and can result in severe penalties if not implemented properly.

• The key is to ensure that the options are priced accurately, which means the business must be valued accurately, the process for which is different for public companies and privately-held companies.

• FASB will accept several different option pricing models, as long as they meet certain criteria and are appropriate to the interest being valued.

The issuance of compensatory stock options for companies, and in particular early-stage technology and biotech companies, continues to be a popular and practical means to motivate employees. It is compelling because it offers the prospect of significant fugure compensation, while defraying the cost of hiring and maintaining top talent. While options promise the possibility of future returns to the recipient, company management should also be aware that immediate tax and financial reporting consequences may occur if proper compliance procedures have not been followed.

With this in mind, 2005 was a very important year for companies that issue stock options. It was the year that Internal Revenue Service (IRS) Section 409A became effective. With Financial Accounting Standards Board (FASB) Statement No. 123 (FAS 123, since revised to FAX 123R), the litany of tax and reporting requirements became even more complex.

TAX CONSIDERATIONS OF OPTIONS ISSUANCE:

How to Avoid Stiff Penalties

Under Section 409A, the IRS established more developed guidelines with severe penalties if a nonqualified deferred compensation plan fails compliance. Of significant importance to the penalties for noncompliance are that they are primarily borne by the employee. All compensation deferred under the plan for the affected employee not subject to forfeiture will become includible in the employee's gross income for the current taxable year. In addition to having the compensation considered to be current income, tax penalties equal to the IRS underpayment rate plus 1% from the time the compensation should have been included in income plus an additional 20% federal income tax penalty would apply. So unless management is not concerned about the cost of dealing with the IRS challenge, employee dissatisfaction, lost productivity, and potental lawsuits levied on the company by the employee, compliance is definitely in the company's best interests.

So how would a compensatory option grant become subject to Section 409A provisions? This would occur if a company were to issue such compensatory stock options with the exercise price set below the fair market value of the underlying common stock. A resulting option that is "in the money" on the grant date would then become subject to the tax acceleration and amplification provisions of 409A.

THE VALUATION PROCESS - SECTION 409A:

Privately Held Companies are Different

There are several steps involved in complying with Section 409A and FAS 123R requirements. The first step is to determine the fair value (per FAS 157) and fair market value (per IRS regulations) of the underlying stock on which compensatory options are being issued.

If the company is privately held, this requires a business valuation to be prepared by a qualified appraiser. In order to value a privately-held company, the appraiser will first determine the fair market value/fair value of the total equity of the company. This involves consideration of the three primary types of valuation approaches: asset, income and market.

Once the total equity value is determined, the second step is for the equity value to be allocated across all shareholder classes of the capital structure. To accomplish this, the appraiser will likely use an option pricing model (OPM) or the probability expected return method (PWERM) to model to a liquidity event at a point in time. Once this allocation process is completed, this results in a per share value on the class of stock on which compensatory options are issued (typically common stock).

This valuation is then used by management to anchor the issuance price for the stock options and therefore keep that grant outside of the undesirable provisions of Section 409A. With the tax issue addressed, the valuation can also be used to assist with the determination of the stock option expense under FAS 123R.

THE VALUATION PROCESS - FAS 123R:

Limits on Pricing Models

In order to determine the fair value of an option grant and resulting costs associated with expensing of this grant, an appraiser will typically select one of the commonly used option pricing models such as Black-Scholes or a Binomial Lattice model. Although FASB does not specify which option valuation model is preferable under FAS 123R, the ruling does require that certain criteria must be met when a company selects an option valuation model:

1. A valuation model needs to be applied consistently with FAS 123R requirements;

2. It has to be based on established and generally accepted financial economic theory;

3. It has to reflect all substantive characteristics of the instrument (i.e. assumptions on volatility, interest rate, dividend yield, expected term, forfeiture rate, exercise price and underlying stockprice).

OPTIONS PRICING MODELS:

Black-Scholes and Beyond

In The pricing of options and other derivatives is a complex area of financial mathematics, involving partial differentiation equations among multiple variables. The most well-known model, the Black-Scholes Option Pricing Model was created in the 1960s by Fischer Black and Myron Sholes, then refined and extended in the 1970s. It is widely used in the financial industry because it is fast and robust; it allows the calculation of a large number of option prices in a short time. Its main weakness, however, is that it performs these calculations only at one point in time, at the expiration of the option. It is not, therefore, rigorously accurate for American-style options that may be subject to early exercise. Binomial Models, however, perform calculations at a number of times, producing a “lattice” or “tree” of potential prices, and revealing most prices an option could assume during its life. Both the Black-Scholes and the Binomial Models are built upon the same theoretical foundation. There are also variants of these models, as well as a number of others.

FINAL CONSIDERATIONS:

A Powerful Tool When Managed Properly

Even if management is preparing the analysis internally, there is a third component of the valuation process that cannot be overlooked. Valuations under Section 409A and FAS 123R should meet a standard of value as well as professional standards. Tax-purposed valuations use "fair market value" as the standard determined under IRS Revenue Ruling 59-60, and financial-reporting valuations follow the "fair value" standard as defined by FASB. The appraiser must also determine which professional standards are required, such as the Uniform Standards of Professional Appraisal Practice (USPAP) and/or the AICPA's Statement on Standards of Valuation Services (SSVS1).

Preparing a valuation with reasonable and defensible analysis that follow the appropriate professional and value standards ultimately leads us back to the premise of this essay. Any one of these steps that are not correctly followed opens the doors for the valuation to be challenged, and the risks become more acute with potential financial repercussions for both company and employee. Gone are the days of a company board "picking" an issuance price for compensatory options that is supported with limited analysis, if any, for a privately-held company.

Given its complexities, issuing stock options can pose a considerable challenge to fast-moving startup companies as well as established private companies. Inconsistent methodologies or dramatic changes in the key inputs from one valuation to the next are primary areas that an auditor will look to challenge. But by understanding the requirements and the risks involved, and ultimately how to manage them, stock options will continue to remain an excellent form of incentive compensation for both company and employee alike.

ABOUT HEMMING MORSE, LLP AND THE AUTHOR

Hemming Morse, LLP advises clients throughout the nation, with a strategic focus on financial and forensic consulting services. Founded in 1958 and headquartered in San Francisco, Hemming Morse has seven offices throughout California. For more information, please visit www.hemming.com.

Carl Saba is a partner and Brian Zacharias is a principal in Hemming Morse's Financial and Forensic Consulting Service Group. They advise companies on valuation issues for financial reporting, tax applications, mergers and acquisitions, and litigation matters. Their valuation expertise includes businesses, intellectual property, options and other complex derivatives. Carl and Brian are founding members and Executive Committee Chairs of the Fair Value Forum and Carl is on the board of the Valuation Roundtable of San Francisco.

They can be reached at sabac@hemming.com and zachariasb@hemming.com