

In Depth

Despite costs, private companies stick with stock options



Insider view

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Stock options have been an important tool for growth companies to provide incentive to recruit and retain top talent and align interests of the management team with investors. Recent tax code and accounting pronouncements have made it more expensive for companies to continue to grant options, yet Silicon Valley startups show no sign of abandoning their option programs.

Internal Revenue Code Section 409A provides potentially devastating tax consequences to the option recipient of mispriced options and Financial Accounting Standards (FAS) 123R requires companies to expense the fair value of stock options starting in 2006. These new rules reduce reported earnings and impose a heavy burden on accounting departments.

Internal Revenue Code Section 409A was created as part of the American Jobs Creation Act that was passed by Congress and signed into law in October 2004. It deals specifically with nonqualified deferred compensation plans. While 409A applies to a broad range of deferred compensation plans, the most pervasive impact for private technology companies applies to discounted stock options (options having an exercise price that is less than the stock's fair market value on the grant date). 409A imposes income tax and a 20 percent federal excise tax on the appreciated value of below market value options which vest after Dec. 31, 2004, and California tacks on an additional 20 percent excise tax.

Options that are subsequently determined in an IRS audit to have been granted at a discount are subject to these taxes and penalties on the appreciated value as the option vests,

even when the employee has not exercised any shares nor has any liquidity. While the company is potentially subject to payroll and withholding taxes and penalties, the exposure to employees is potentially ruinous. Increasingly, venture funded companies are unwilling to subject their employees to this risk and are taking steps to achieve a safe harbor through reliance on a common stock valuation performed by independent valuation firms.

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Essentially, the board of directors must determine the fair market value of the common stock each time it grants options and assess whether the most recent valuation can still be relied on. By legislation, a valuation cannot be relied upon for more than one year.

Over the last six months, we have seen a new wrinkle at private companies as the company's auditors are increasingly reviewing the 409A valuations in conjunction with FAS 123R accounting for stock options which became effective in 2006. This has raised the bar for documentation of the 409A valuation report which must also comply with the American Institute of Certified Public Accountants (AICPA) guidelines for valuing private equity securities. Many auditors believe that the guidance under FAS 123R is more stringent than that under IRS Code Section 409A. Therefore companies must ensure that the calculations in their 409A valuations conform to FAS 123R rules as well.

In certain cases, inadequately documented 409A valuations have not stood up to audit review, resulting in the very 409A exposure

that they were intended to preclude. To avoid these pitfalls, companies are encouraged to have their auditors contemporaneously review the 409A valuations and have both the 409A and 123R valuations performed simultaneously.

Accounting and tax rules promulgated by FAS 123R mean that nonpublic companies must do much more than simply administer their option grants for vesting, exercises and forfeitures. Compensation expense must be correctly allocated over multiple accounting periods and there are new accounting rules regarding deferred tax assets and "as-if APIC pools." This accounting is complicated and tedious and requires analysis of key factors such as volatility, expected term of the option and estimated forfeiture rates used in recognition of non-cash compensation expense.

Legacy stock option administration systems have notoriously poor to non-existent FAS 123R accounting capabilities. There are a few recent system solutions with robust FAS 123R reporting, in some cases combined with option administration capabilities. Automation of the FAS 123R / stock option administration process facilitates SOX compliance and a more efficient audit process. It should also provide significant cost savings compared to manual analysis.

The cost and overhead associated with granting options has increased significantly in recent years but options continue to be a key recruiting tool for venture funded companies. Most Silicon Valley companies are stepping up and bearing the expense which, despite the grumbling, is now generally considered another cost of doing business.

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