Stock Valuation and Stock Pricing Alternatives

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Publicly traded companies, venture capital firms, and private equity firms are now dealing with the same set of financial accounting & reporting, tax reporting and disclosure requirements related to their stock options. These requirements include Financial Accounting Standards (FAS) Statement #123 - Accounting for Stock based Compensation, FAS 123(R) - Share-based Payment, Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 107, and Internal Revenue Code (IRC) Section 409A regulations, which all provide guidance on valuation for purposes of valuing stock options and setting the stock option exercise price.

FAS Statement #123 dealt with the voluntary expensing of the cost of employee stock options (ESOs), and FAS Statement #123(R) requires a public entity to measure and recognize the cost of the employee stock option based on the options grant-date fair value, where the grant date fair value will be estimated using option-pricing models adjusted for the unique characteristics and features of those financial instruments. FAS #123(R) also contains related guidance on certain tax issues associated with ESOs and disclosures that must be provided in the notes to the financial statements. SEC-SAB No. 107 contains implementation guidance emphasizing that the “grant date fair value” should be the equivalent of an exchange price for ESOs. All of these regulations have three main parts: 1) the fair value measurement of the financial instrument, 2) recognition on the balance sheet and 3) recognition of the compensation cost of ESOs in the income statement.

Major Risk Areas

The 2004 passage of the American Jobs Creation Act brought with it the addition of IRC Section 409A. Section 409A carries potentially burdensome tax implications for the company and key executives or other individuals compensated under non-qualified deferred compensation plans.

Board of director compensation committees must now exert due diligence and extreme care to structure company plans in such a way as to comply with the requirements of IRC Section 409A. The major areas for risk and uncertainty reside in following stock option valuation areas:

a) The way stock options are valued, the methods used and the reasonability of the methods
b) Whether or not the valuation methods utilize established economic and financial theories used in the valuation field
c) The option strike price as compared to the fair market value of the underlying common stock at the grant date
d) The likelihood of forfeiture of those stock options before the vesting period

Boards of directors and their related compensation committees are concerned about potential liability for the company, tax implications for key employees and the adverse consequences resulting from:

a) Unpaid withholding taxes due upon option vesting,

b) Employees incurring ordinary income tax, 20% additional tax penalties, and interest charges under Section 409A if discounted options are granted inadvertently

c) Any potential litigation that may result from the above mentioned circumstances.

Many boards may wish to rely on outside experts for their valuations to minimize such exposure thereby strengthening their position with the IRS in the event of an audit. Newbury Piret has outlined its valuation approach and solution below in order to assist your company to mitigate the risks outline above.

Other companies may respond to IRC Section 409A regulations in any of the following three ways:

1) Status Quo - A company may choose to retain its existing option pricing practice. If the company's option exercise prices equal or exceed the fair market value of the underlying stock, Section 409A generally will not apply to such options (see the flow chart detailed below). This is true whether or not the company applies any of the rules or factors set forth in the proposed regulations. If the company's option exercise prices are later found to be below fair market value upon audit by the IRS, then the burden will be on the company to prove that its stock valuation method was reasonable by referencing the standards and rules found in the tax code regulations. If the company's current valuation method doesn't consider or reference the factors and methods outlined in the tax regulations, or if it uses no valuation method at all, the company will fail to satisfy this burden, and the adverse consequences of Section 409A will apply.

2) Informal Valuations Using Specified Factors - A company may choose to perform its own internal stock valuation based on specified factors set forth in the regulations, which are called "general valuation factors." If the company's option exercise prices are later found to be below fair market value, then the burden will be on the company to prove that its stock valuation method was reasonable. The company will improve its chances of satisfying this burden if it employs the factors specified in the regulations.

3) Adopt One of the New "Presumptive" Methods - A company may choose to adopt one of the "presumptive" stock valuation methods set forth in the regulations, thereby putting the burden on the IRS to prove that both the company's stock option prices are below fair market value and the company's application of the presumptive method was "grossly unreasonable."

These presumptive methods are described below. They involve either a written valuation by an appraiser or other person with knowledge and experience in stock valuation, or a binding formula.

Presumptive Valuation Methods

The regulations specify three methods that will be presumed reasonable if consistently used for all of an employer's equity-based compensation arrangements. The valuation resulting from any of these presumptive methods will be considered to be fair market value and may only be rebutted by the Internal Revenue Service if the company's application of the method is found to be "grossly unreasonable." The three presumptive methods are as follows:

1) Independent Appraisal Presumption. A valuation performed by a qualified independent appraiser using traditional appraisal methodologies (as would be applicable to an appraisal of common stock for estate tax planning or an employee stock ownership plan ESOP) will be presumed reasonable if it values the stock as of a date that is no more than twelve months before the applicable stock option grant date. However, this presumption would not apply if events subsequent to the appraisal date have a material effect on the company's stock value.

2) Illiquid Start-Up Presumption. A special presumption is provided for "illiquid stock of a start-up corporation." A start-up corporation is defined as a corporation with no publicly traded stock that has conducted business for less than 10 years. A valuation of illiquid start-up stock will be considered reasonable if five requirements are satisfied:

a) The valuation is evidenced by a written report;

b) The valuation takes into account the General Valuation Factors described below. As indicated below, events subsequent to the valuation must be taken into account and may render an earlier valuation inapplicable;

c) The valuation is performed by a person with significant knowledge and experience or training in performing similar valuations;

d) The stock being valued is not subject to any put or call right, other than the company's right of first refusal or right to repurchase stock of an employee (or other service provider) upon termination of service;

e) The company does not reasonably anticipate an IPO, sale or change in control of the company within twelve months following the equity grant to which the valuation applies.

The valuation factors specified in the regulations incorporate the following:

- The tangible and intangible assets of the company
- The present value of future cash flows
- The public trading price or private sale price of comparable companies
- Control premiums and discounts for lack of marketability
- Whether the method is used for other purposes
- Whether all available information is taken into account in determining value.

Even if a valuation applies these factors, it will not be considered reasonable if it is more than twelve months old. In addition, significant events occurring even before the twelve month anniversary will require the valuation to be updated. Such events would include:

- The possibility of/or plans for a future investment in the company by an outside investor,
- An initial public offering or sale of the company,
- Resolution of material litigation
- The issuance of a patent.

3) Binding Formula Presumption. A valuation based on a formula used in a shareholder buy-sell agreement or similar binding agreement will be presumed reasonable if the formula price is used for all non-compensatory purposes requiring the valuation of the company's stock, such as regulatory filings, loan covenants, and sales of stock to third parties. This method will not be available if the stock may be transferred other than through operation of the buy-sell or similar arrangement to which the formula price applies. Because of the restrictive conditions on use of this presumption, we do not expect it to be widely utilized by private technology and life sciences companies.

Newbury Piret & Co. Stock Option Valuation Solution

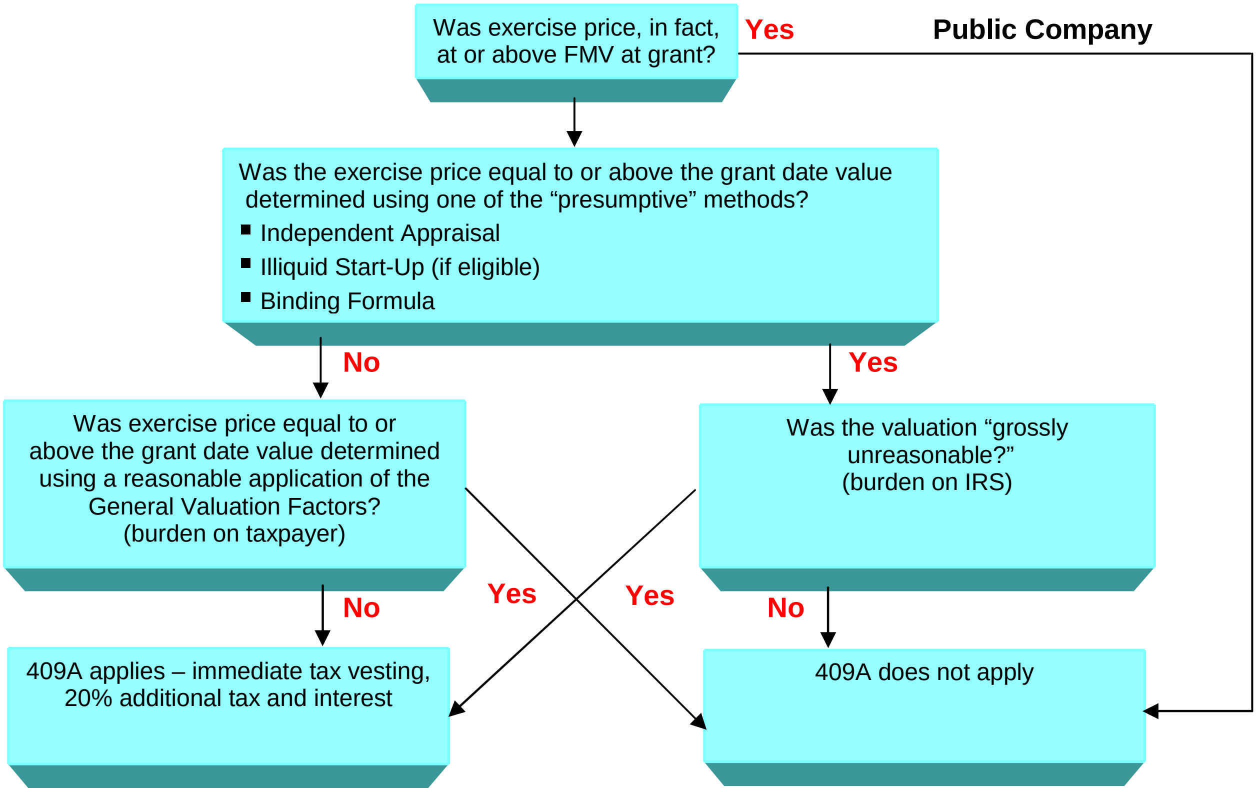
Newbury Piret will provide a valuation analysis and report that will stand up under rigorous IRS scrutiny. Our stock and stock option valuation analysis will consider all three basic approaches to value: income, market/sales comparison and cost.

Where more than one approach is utilized to form an opinion of value, the results of each approach will_ be reconciled giving consideration to the type of asset, the applicability of the approach, and the nature and reliability of the data used. Our valuation will take into consideration many factors that influence the fair market value of closely held common stock and employee stock options including, but not limited to, the following:

- The nature and dynamics of the Company's business, including its lines of business, its competitiveness, its customer base and management strength;
- The economic and operating outlook of the Company business and its historical and prospective operating results;
- The book value of the stock and the financial condition of the Company as of the valuation date and its capability to finance and sustain future operations;
- Valuation of the Company's business by estimating the present value of its projected operating net cash flow, as well as analyzing the earning and dividend paying capacity;
- Analyzing the enterprises intangible assets and goodwill;
- Correlation of the public market price (and corresponding investor ratios) of common stocks of corporations engaged in lines of business similar to the Company that have their stocks traded in a free and open market, either on an exchange or over-the-counter;
- Examining the recent sale of stock and the size of the block of stock to be valued;
- The transfer features and characteristics of the common stock and employee stock options including their marketability and vesting restrictions.

Our valuation study will be executed in accordance with practices currently accepted and utilized by the financial and valuation communities and in conformity with the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board of the Appraisal Foundation, as well as meet the requirements of IRS Revenue Ruling 59-60 of the Tax Code.

STOCK OPTION PRICING FLOW CHART



Conclusion

The Section 409A regulations, along with recent changes in the FAS Statement #123, 123(R), and SEC-SAB No. 107 financial accounting rules and practices will motivate the need for stock option pricing and compensatory stock valuation among venture capital firms, private equity and public companies. Boards of directors should be consulting with valuation specialists to determine how best to address these changes. You can contact us by calling Ronald J. Adams, CPA, Managing Director – Valuations, at Newbury Piret & Co. (617) 367-7300; ext.#115 for a free consultation.

__Ron Adams, CPA__ is Managing Director at Newbury Piret. Mr. Adams is responsible for valuation services as it relates to financial accounting and reporting, gift and estate tax planning, income tax planning, equity buy/sell, and for internal planning purposes.

<u>**Sources**</u>:

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<u>Financial Accounting Standards Board - Statement of Financial Accounting Standards No. 123 – Accounting for Stock-Based Compensation,</u> October 1995

<u>Cooley Godward, LLP –</u> Article, October 19, 2005

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