Fair market value?

How FASB, IRS rules are changing employee stock options **Interviewed by Paul R. Harvey**

The last few years have produced a resurgence of private equity companies investing in start-ups at a more sustainable rate than the late 1990s and early 2000s. A common way for these fledgling businesses to attract and retain top-flight employees is to offer them a share of the company through employee stock options.

But private companies using or considering the use of stock options to supplement employee compensation should be aware that key revisions to the Financial Accounting Standards Board (FASB) guidelines and IRS tax rules governing these options might dramatically impact their current or future stock option programs.

"Compliance with both pronouncements is based upon accurate determinations of the fair market value or fair value for stock options when they are issued," says Jeff Stegner, a partner at Armanino McKenna LLP in San Ramon. "While this is not a difficult issue for publicly traded companies, the overwhelming majority of privately held companies that are issuing stock to their employees must retain a qualified professional to value these options."

Smart Business spoke with Stegner about the FASB and IRS rule changes and what they mean to private companies offering or considering employee stock option programs.

What key elements of the FASB and IRS pronouncements impact employee stock options?

For private companies, FAS 123(r) went into effect on Jan. 1, 2006, stipulating that costs related to equity-based compensation be recognized in a company's income statement. We have received a large number of calls on this issue from companies at the behest of their auditors, who can't issue their audit opinion until this requirement is completed.

The Internal Revenue Service jumped on the bandwagon in October 2005 and issued 409(a), a measure that requires companies to report compensation to their employees if stock options were granted to them at strike prices below fair market value.

Jeff Stegner
Partner
Armanino McKenna LLP

How are these pronouncements prohibitive to private companies?

A private company offering employee stock options must prove that it has set the exercise price of the stock option equal to the value of the common stock. The days when the board of directors could select a price and say, 'Yes, that's the right number' are over. Companies now must either follow a set of specific steps for valuation or hire an independent valuation professional to calculate their stock's fair market value.

The reason companies are considering employee stock options in the first place is to attract and retain qualified employees while preserving operating cash flow. In my experience, the percentage of companies that have this in-house resource with available time is very small.

Why is it crucial for employees that option prices be properly calculated?

Your auditor will generally require a valuation to verify you have properly recorded the noncash charge for granted options. But — perhaps more important — a valuation can protect your employees from substantial income taxes and penalties if the IRS determines options are priced at less than fair market value. Obviously, management was handed the largest number of options, so it's going to impact their bottom line the most.

For example, let's say the option for the fair value of the stock is determined to be 10 cents. If employees were granted the option at a penny per share, the nine-cent spread is now taxable to them, but what do they really have?

They have an option to purchase shares in a company that is not publicly traded and may never reach a stage where they are able to realize a gain from the options, yet they can be charged current income tax on them even if they never exercise the option.

What does a company gain from a professional valuation of its stock?

No one is interested in what start-ups are doing today; they're interested in the upside potential next week, next year or in five years. But you can bet that IRS auditors are going to look closely at big, splashy news headlines like Google's acquisition of YouTube and others.

If your start-up eventually realizes a large liquidity capital event worth many multiples of the original option price(s), the IRS is going to ask how you determined the fair market value of the stock at the time of the option grant and decide if you complied with the 409(a) valuation rules.

What actions should be considered before implementing stock options?

Most important, companies should not be afraid to offer stock option plans. With proper implementation, stock options are the lifeblood for successful companies generating and advancing new technology.

The key to a successful plan is following the rules and utilizing an experienced, independent appraiser to value the shares of your company.

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