Reasonable Stock-Based Compensation: Valuation of Common Stock in Compliance with Internal Revenue Code Section 409A, SFAS No. 123(R), and AICPA Practice Aid Guidance

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Both public corporations and private corporations may have to deal with stock valuation methods to measure (and disclose) stock-based compensation amounts. Such amounts may have to be reported on the corporation's financial statements and such amounts may have to be reported on the corporation's income tax returns. Serious negative consequences (to the corporation and to the executives) may result if the subject company does not comply with the appropriate professional guidance with regard to the measurement of stock-based compensation. This discussion summarizes some of the most commonly referenced professional guidance with regard to the valuation of stock and stock options for stock-based compensation reporting purposes.

Introduction

Valuation analysts typically rely on professional guidance regarding the appropriate common stock valuation methods with regard to the measurement of reasonable stock-based compensation. Such professional guidance has been issued by:

1. the Treasury and Internal Revenue Service (e.g., Internal Revenue Code Section 409A),
2. the Financial Accounting Standards Board (e.g., SFAS No. 123(R)), and
3. the American Institute of Certified Public Accountants Practice Aid (e.g., *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*).

The objective of this discussion is to provide an overview of this professional guidance with regard to the measurement of stock-based executive compensation. The purpose of this discussion is to assist a corporation board of directors in the assessment of a valuation of stock-based compensation. Corporation directors typically make such an assessment to assure themselves that such compensation-related valuations comply with the published requirements.

Directors should be particularly interested in the measurement of stock-based executive compensation. This is because the corporation's failure to meet these valuation requirements may result in the following unfavorable consequences:

1. Section 409A compliance failure—severe corporation and individual income tax penalties;
2. SFAS No. 123(R) compliance failure—delayed, restated, or amended financial statement filings; or
3. American Institute of Certified Public Accountants (AICPA) guidelines compliance failure—delayed, restated, or amended financial statement filings.

Internal Revenue Code Section 409A

Overview

Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includable in gross income, unless certain conditions are met. The Internal Revenue Service and the Treasury Department are currently in the process of finalizing the proposed regulations under Section 409A.

In October 2006, the Service announced that the transition period of compliance with proposed regulations under Section 409A would be extended through January 1, 2008. Until final regulations are issued and become effective, compliance with the proposed regulations (which were published on October 4, 2005), is deemed to be good faith compliance with Section 409A.

Section 409A significantly affects how private companies set (1) stock values for stock-based compensation arrangements and (2) the exercise prices for such stock options. Section 409A imposes severe tax penalties on noncompliant deferred compensation arrangements. Such noncompliant arrangements include stock options granted with an exercise price below the fair market value of the company's stock as of the date of the grant.

Under Section 409A, stock options and stock appreciation rights that are granted with an exercise price less than the fair market value of the company stock could result in:

1. significant negative tax consequences for the option recipient and
2. potential negative tax consequences for the corporate employer.

The negative tax consequences to the corporate employer would result from a failure to report and withhold on appropriate income amounts with respect to the stock option award.

An option granted below fair market value under Section 409A will result in (1) the recognition of income by the option holder as the option vests (rather than when it is exercised), plus (2) an additional 20 percent tax penalty. As a result, corporate directors should make efforts to ensure that any common stock valuation used in conjunction with stock option grants is performed by an independent financial adviser familiar with the guidelines outlined in Section 409A.

Stock Valuation and Stock Option Pricing

In order to avoid the negative income tax consequences associated with Section 409A, the following valuation guidelines are appropriate for both public and private corporation stock.

Public Corporation Stock

Section 409A provides that, for stock that is readily tradable on an established securities market, the fair market value of the stock may be determined based on:

1. the last sale before or the first sale after the grant,
2. the closing price on the trading day before or the trading day of the grant, or
3. any other reasonable basis using actual transactions in such stock as reported by the market and consistently applied.

This determination of fair market value may also be based on an average selling price during a specified period that is within 30 days before or 30 days after the grant. This fair market value determination basis may be used provided that:

1. the commitment to grant the stock right based on such valuation method must be irrevocable before the beginning of the specified period, and
2. such valuation method must be used consistently for grants of stock rights under the same and substantially similar programs.

Private Corporation Stock

Section 409A provides that, for stock that is not readily tradable on an established securities market, the fair market value of the stock means a value determined by the "reasonable application of a reasonable valuation method."

Fair market value is not specifically defined in Section 409A. In Revenue Ruling 59-60, fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

The determination of whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, is made based on the facts and circumstances as of the valuation date.

According to Section 409A, the factors to be considered under a reasonable valuation method include:

- the value of tangible and intangible assets of the corporation,
- the present value of future cash flow of the corporation,
- the market value of stock in similar corporations engaged in substantially similar businesses, the value of which can be readily determined through objective means (such as through trading prices on an established securities market or an amount paid in an arm's-length private transaction), and
- other relevant factors, such as ownership control price premiums or discounts for lack of marketability.

In addition, the valuation method should take into consideration all available information material to the value of the taxpayer/employer corporation stock.

Under Section 409A, it is not reasonable to rely on a valuation methodology as of a later date if:

1. the valuation date was more than 12 months prior to the date for which the valuation is being used or
2. the valuation fails to reflect information available after the date of the valuation that may materially affect the value of the company (for example, the issuance of a patent).

In either of the above two situations, an updated stock valuation would be required.

Valuation Safe Harbors—Private Corporation Stock

Section 409A provides for three "safe harbors" related to valuing private corporation stock. Consistent reliance on these safe harbor methods by a corporation board of directors will result in a presumption of a reasonable valuation.

The Service could then rebut the safe harbor methods only by showing that (1) the valuation method or (2) the application of the valuation method was grossly unreasonable.

The three safe harbors include the following:

- **Safe Harbor #1**—Valuation for Private Corporations

  Private corporations should retain an independent business valuation firm to provide a business valuation report that satisfies the requirements of Section 409A for relevant transactions (e.g., stock option grants). The business valuation report should be prepared by an individual who has earned a relevant valuation professional credential (e.g., ASA, ABV, or CFA).

  In addition, according to Section 409A, the business valuation report should not be outdated. A business valuation report that is more than 12 months old or that does not reflect significant developments that have occurred should not be relied on for relevant transactions.

- **Safe Harbor #2**—Valuation for Start-Up Private Corporations

  Section 409A provides a separate safe harbor for start-up private corporations. The regulations define start-up private corporations as corporations that:

  1. have been in business for less than 10 years,
  2. do not have a class of equity securities that is traded on an established market, and
  3. have a board of directors that does not anticipate being acquired or going public within 12 months from the date for which the valuation is needed.

  Start-up corporations should also base stock valuations for relevant transactions (e.g., stock option grants) on a written report that takes into account the relevant factors outlined in Section 409A. The stock valuation "will not be treated as made reasonably and in good faith unless the valuation is performed by a person or persons with significant knowledge and experience or training in performing similar valuations."

- **Safe Harbor #3**—Formula Price

  According to Section 409A, a stock valuation based on a formula (e.g., pricing multiple of book value or pricing multiple of earnings) would be considered in certain unique circumstances to represent the fair market value of the stock.

  For this safe harbor to apply, this formula price should be used consistently to value the corporation stock for all purposes, including noncompensatory purposes. Such noncompensatory purposes would include: third-party transactions, regulatory filings, loan covenants, and issuances to and repurchases of stock from nonemployees.

SFAS No. 123(R)

Overview

SFAS No. 123(R) requires that the cost resulting from all share-based payment transactions (including grants of stock options to employees) be recognized in financial statements based on fair value. Under SFAS No. 123(R), companies are required to recognize the fair value of stock option grants as compensation expense in their financial statements.

Fair Value

Fair value is defined in SFAS No. 123(R) as "the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale."

Valuation Criteria

According to SFAS No. 123(R), "observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used as the basis of measurement of equity and liability instruments awarded in a share-based payment transaction with employees."

If observable market prices are not available, fair value should be estimated by using "a valuation technique that (a) is applied in a manner consistent with the fair value measurement objective and other requirements of this Statement, (b) is based on established principles of financial economic theory and generally applied in that field, and (c) reflects all substantive characteristics of the instrument."

SFAS No. 123(R) does not specify a preference for a particular valuation method or model to establish the fair value of employee stock options. A lattice model (for example, a binomial model) and a closed-form model (for example, the Black-Scholes formula) are among the valuation methods that meet the criteria required by this FASB Statement.

According to SFAS No. 123(R), the selected stock option valuation model should take into account, at a minimum:

1. the exercise price of the option,
2. the expected term of the option,
3. the current price of the underlying share,
4. the expected volatility of the price of the underlying share for the expected term of the option,
5. the expected dividends on the underlying share, and
6. the risk-free rate for the expected term of the option.

AICPA Practice Aid

Overview

The AICPA practice aid entitled *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* provides guidance regarding the valuation of equity securities issued by private corporations. Such private corporations include corporations that have filed with a regulatory agency in preparation for the sale of any class of their securities in a public market.

In particular, the AICPA practice aid was issued, in large part, to address "cheap stock" issues. In a typical cheap stock situation, a private corporation issues stock options as part of a compensation package provided to its employees. At the time the stock options are granted, the board of directors determines the fair value of the stock in order to determine the appropriate exercise price.

As part of an initial public offering (IPO), the Securities and Exchange Commission (SEC) will review a corporation's registration statement. The SEC will (1) examine historical stock option grants and (2) determine whether a company has the required support for the determination of the fair value.

If the SEC determines that the stock options were granted below fair market value, the company may be required to record a "cheap stock charge." This charge will result in additional compensation expense being recognized by the corporate IPO candidate.

Although the AICPA practice aid does not represent authoritative guidance, it is generally relied on by auditors and by the SEC. It is relied on as a guide to the appropriate methodology to estimate the fair value of noncontrolling interests in the common stock of private companies for stock option grant purposes.

Concept of Fair Value

Fair value is defined in the AICPA practice aid as "the amount at which a minority common stock interest in a privately held enterprise could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale." According to the AICPA practice aid, a valuation performed for the purpose of valuing privately issued securities should be based on fair value, as defined in the accounting literature.

Valuation Methodology

The focus of the AICPA practice aid is on the appropriate methodology to estimate the fair value of noncontrolling ownership interests in the common stock of private corporations. The fair value valuation methodology is presented as follows:

- **Enterprise Value**: First, the AICPA practice aid provides an outline presenting the approaches generally applicable to estimate the fair value of the equity securities of an enterprise—without consideration of the complexities of the enterprise's capital structure.
- **Enterprise Value Allocation**: Second, the AICPA practice aid provides guidance regarding the appropriate methodology to allocate the fair value of an enterprise to various stockholders for corporations having a capital structure that includes multiple classes of preferred stock and common stock. The various methods to enterprise value allocation described in the AICPA practice aid are divided into three categories:
    1. the probability-weighted expected return method,
    2. the option-pricing method, and
    3. the current-value method.

Probability-Weighted Expected Return Method

Using this method, the value of the common stock is estimated based on an analysis of future values for the enterprise assuming various future outcomes. The value per share of the common stock is then based upon the probability-weighted present value of the expected future returns, considering:

1. each of the expected future outcomes and
2. the ownership rights of each class of stock.

The expected future outcomes in this model generally include continued operation as a going concern, merger or sale, IPO, or liquidation.

Option-Pricing Method

The option-pricing method treats both the preferred stock and common stock as call options on the corporation's enterprise value. Exercise prices for the options are based on the liquidation preference of the preferred stock.

In the option-pricing method, common stock is considered to be a call option with a claim on the corporation enterprise value. The common stock is assumed to have an exercise price equal to the remaining value immediately after the preferred stock is liquidated.

The Black-Scholes option pricing model is commonly used to estimate the value of the common stock using the option-pricing method.

Current-Value Method

The current-value method is based on the following valuation procedures:

1. Estimate the corporation enterprise value using the market, income, or asset-based approach.
2. Allocate the corporation enterprise value to the various series of preferred stock based on the greater of their liquidation values or their conversion values.
3. The remaining value after the allocation of corporation enterprise value to preferred stock is the value of the common stock.

AICPA Practice Aid Enterprise Value Allocation Method Recommendations

The AICPA practice aid recommends that the allocation method selected should reflect the expectations regarding stockholders about (1) expected future economic events and (2) the timing and uncertainty of future cash flow.

In addition, the selected allocation method should assign some value to the common stock (1) unless the subject corporation is in liquidation and (2) the common shareholders will receive no cash.

Although the probability-weighted expected return method is complex, the primary benefit of this method is that:

1. it is forward-looking and
2. it considers the terms of the shareholder agreements.

The option-pricing method is generally appropriate in circumstances in which (1) the range of possible future outcomes for the subject corporation is difficult to predict and (2) forecasts would be speculative.

According to the AICPA practice aid, the current-value method is only appropriate when:

1. a liquidity event is imminent, or
2. the subject corporation is at an early stage of development.

An early stage of corporate development means that no progress has been made on the business plan and no significant value has been created in the common stock above the preferred stock liquidation preference.

Summary and Conclusion

This discussion presented an overview of the available professional guidance regarding the appropriate common stock valuation methods for reasonable stock-based compensation. In particular, this discussion focused on the professional guidance that has been issued by (1) the Treasury and Internal Revenue Service (Section 409A), (2) the FASB (SFAS No. 123(R)), and (3) the AICPA (the practice aid entitled *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*).

In assessing the reasonableness of stock-based compensation, corporation boards of directors should consider the following guidelines:

- Boards of directors of private corporations: Retain an independent business valuation firm to produce a business valuation report as of the date of issuance of stock-based compensation (e.g., stock option grants) that satisfies (1) the requirements of Section 409A and (2) the guidance outlined in the AICPA practice aid entitled *Valuation of Privately-Held-Company Equity Securities Issued as Compensation.* This procedure should ensure that the subject corporation stock-based compensation is reasonable.
- Boards of directors of public corporations: Retain an independent business valuation firm to produce a business valuation report as of the date of issuance of stock-based compensation (e.g., stock option grants) that satisfies the requirements of SFAS No. 123(R).

  This procedure should ensure that the fair value of the stock option grants is recognized appropriately in the corporation financial statements.

A corporation board of directors that follows this professional guidance should ensure that any valuation of stock-based compensation both passes regulatory review and avoids the negative consequences of (1) severe income tax penalties and/or (2) delayed, restated, or amended financial statement filings.

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