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See pages 4-5.*

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Valuing Options While Running the Compliance Guantlet, Part I of II

by Edward E. Pratesi, CPA, Brentmore Advisors, LLC

Value, as we know is in the “eyes of the beholder.” Certainly we know that transaction value is important in “pricing” rounds of venture capital financing and is critical in determining exit multiples during an IPO or M&A event. But distinctions should be drawn between “transaction” oriented valuations and what is often called “compliance” based valuation. Compliance-based valuation refers to a business valuation assigned to such assets as:

- The value of stock options or stock based awards issued by either publicly-traded or privately-held companies (FASB 123R, IRC Sec. 409A, SEC “Cheap Stock” review).
- The allocation of the purchase price and determination of goodwill in the context of a business combination (FASB 141R).
- The testing for impairment of goodwill acquired in a business combination (FASB 142).

Both publicly traded and privately traded companies are impacted by these compliance and reporting requirements. For financial reporting purposes (GAAP accounting), the Financial Accounting Standards Board (FASB) has promulgated reporting standards under 123R, 141R, 142 and 157 – which defines the concept of “fair value” for financial reporting purposes. The Internal Revenue Service, with Code Section 409A and its proposed regulations, impact any firm considering stock-based compensation. And finally the Securities and Exchange Commission (SEC) encourages adherence to the standards promulgated by the FASB and provides oversight on the valuation and issuance of stock-based compensation and stock options.

The cost of being out of compliance with one or more of the above rule making bodies can result in additional taxes, penalties and interest under IRS rules to a possible restatement of financial statements for additional compensation expense and possibly other sanctions by the SEC upon an IPO event.

Our focus is upon privately-held companies and the compliance issues they face when providing stock options or a form of stock-based compensation. Compliance is critical in these areas as option grants and stock awards

(continued on page three)

are vital springboards to attract and retain employees.

In the Beginning...

The days of easy money and stock options are history. A “brave new world” of regulation and structure has forced technology based companies to recast their stock option and stock-based compensation strategies. Now, two outside regulatory forces are forcing companies to approach stock options and related stock-based compensation as a valuation exercise.

Enter the Dragon...

The issue facing the investment community and industry was an attack on the concept that stock options issued at a price at least equal to the proximate market value of the underlying share price had no cost to the issuing company. The theory was since issuing options cost the company nothing, the options had no value or cost and could not be valued. By 2004, opponents of this belief convinced Congress and the regulatory agencies to move towards recognizing options as expenses.

To address this issue, the Financial Accounting Standards Board, which controls the financial reporting standards otherwise known as GAAP, issued Statement #123 – Accounting for Stock-Based Compensation in 1995 that modified the rules under which companies reported the issuance of stock options. But it was not until 2004, with the issuance of FASB 123R (revised), that stock options and stock-based compensation needed to be addressed by both publicly-traded companies and non-publicly traded companies.

Simply stated, FASB 123R requires the estimation of the fair value of an employee stock option as of the grant-date and the recognition of that cost. The determination of the fair value of the option can be estimated by using option pricing models similar to the Black-Scholes Option Pricing Model (BSOP). An explanation of the BSOP Model and formula is beyond the scope of this article but the most important inputs to the model are the option strike price (the price at which the option can be converted into the underlying stock), a risk-free interest rate, the time to maturity for the option—the expiration date of the option, the underlying price of stock and a volatility factor.

Of these input requirements, two are very difficult for privately-held companies to quantify. The underlying stock price has not been determined by the market and the volatility factor, which refers to the standard deviation of the change or variability in the value of a security over a specific time period, is not easily calculated because the security isn't being publicly traded.

The 123R group states that companies can use either internal resources or outside professionals to *(continued on page six)*

“Almost all publicly-traded companies that issue financial statements prepared by CPA’s conform to GAAP. Increasingly, privately-held companies are being held to the same standards by their funding sources.”

*—Edward Pratesi,
Brentmore Advisors*

value a company's stock. But many of the companies issuing stock options are technology-based firms with complex capital structures, multiple classes of preferred/common stock, and varying shareholder rights, liquidation preferences and conversions. It's rare that these companies have the expertise to develop objective valuations that meet compliance criteria. And once a value **has** been placed on securities, the quest for a volatility factor begins. FASB 123R guidance "indicates" that volatility (the **key value driver** in this model) may be estimated by referencing comparable publicly-traded companies or, if this isn't feasible, a volatility estimate can be calculated by using an industry-sector index.

Round 2 ...The IRS Issues Code Section 409(A)

In 2004 Congress passed the American Jobs Creation Act (the law has certainly created more jobs for accountants), which brought with it a myriad of federal tax rules governing deferred compensation and a broad definition of deferred compensation which included stock options and stock appreciation rights issued at a discount to Fair Market Value (FMV). Penalties apply to stock awards unless they meet the requirements of Internal Revenue Code 409(A).

For these privately held companies the new code section influences:

- The methods used to value the company and its options.
- The reasonability of the methods used.
- Whether the valuation methods used conform to economic and financial theories in use in the valuation field.
- The option strike price compared to the fair market value of the stock upon issuance.
- The likelihood of forfeiture before expiration.

The IRS-provided guidance for privately-held companies issuing options, specifically, that the FMV of the underlying security as of a valuation date (usually the grant date) means value determined by "a reasonable application of a reasonable valuation method." The determination of "reasonable" is a facts and circumstances test, with the IRS holding that if **one** of the below "presumptions" is met, the valuation is reasonable:

The binding formula presumption—wherein valuation of the underlying security is determined by a formula such as a multiple of earnings or book value provided, however, that this valuation method is used consistently for the issuance of stock for other purposes, including non-compensatory transactions such as stock sales to third-parties, including for example, venture capital transactions.

The independent appraisal presumption—where a qualified independent appraiser using traditional appraisal methods—as would be applied for example in the valuation of a company for estate tax compliance or for an ESOP —will be presumed to be reasonable if the valuation date is no more than 12 months before the option grant date.

The illiquid start-up presumption—a special exemption is made for the stock of an illiquid start-up corporation, defined as a corporation with no publicly traded stock that's been in business for less than 10 years.

Needless to say, there are many traps and considerations for privately held companies in developing and implementing a stock option or stock-based compensation strategy. In our next article we will explore these compliance issues and analyze strategies based on "stage of growth" and proximity to an exit event.

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*Our VC analysis enforces
our belief that while the
US economy is mildly
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is not falling.
See pages 4-5.*

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Valuing Options While Running the Compliance Gauntlet, Part II of II

by Edward E. Pratesi, CPA, Brentmore Advisors, LLC

It is important to note again the differences between FASB 123R and IRC Section 409A as they appear to be similar but approach the valuation of options and securities from different perspectives. FASB 123R concerns stock option valuations for financial reporting purposes and is measured from the **issuing company's** perspective. The objective is, in the case of privately-owned companies, to place a value on stock options in order to treat its value as an expense on an income statement.

IRC 409A is concerned with the issuance of stock based compensation—either in the form of stock options or other types of securities—by either publicly-owned or privately-owned firms. The objective is to ensure that the securities being granted, whether in the form of stock options or stock, are granted at fair market value. If they're not, the individuals receiving the stocks may be socked with taxes, interest and penalties.

Under either regimen, the value of the underlying security—the common stock—is critical in determining the value of a stock option. For publicly-owned companies, obtaining the price of the common (share) is as easy as opening the Wall Street Journal (or going online). Privately-owned companies do not enjoy the same luxury.

In order to provide additional insight into the complexity and overlap between these two reporting “standards,” I’ve provided a series of questions with answers that address a number of the issues impacting privately-owned companies.

Q. Which one of the above standards will impact us the most?

A. Since most privately-owned technology based companies will be issuing stock options (and in many cases more than once a year), anticipate that a valuation of the underlying stock will be needed to meet IRS standards first and the financial reporting requirements under 123R second.

Q. If both the FASB and IRS require that our privately-owned company be valued, can we have one *(continued on page three)*

valuation report prepared to meet both standards?

A. Maybe. When the FASB issued 123 and 123R (Revised), the definition of value did not conform to the definition of value under IRS rules or the fair market value standard. The reporting standard of value under 123R is fair value and in some situations a different value can result. If you are issuing stock options and want to ensure the valuation report will comply for both purposes, be sure to send the report to your auditors and ask the question: “Do you agree with the methodologies employed in our valuation report?” Your auditor will determine if the valuation report meets the appropriate auditing standards.

Q. My company has both common and convertible preferred stock outstanding—in fact more than one series of preferred stock. We are interested in issuing additional stock options to our key employees. What do we need to do?

A. It is not uncommon for a technology company to have several classes of stock outstanding, tracking different various rounds of VC financing. The valuation process can be divided into three steps, determining the **equity value of the enterprise**, modeling the **economic and control rights** for each class of equity, and then **allocating the equity value** among the classes.

The AICPA has issued a “practice aid” entitled *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* that provides both valuation experts and auditors with guidance on typical valuation methods employed by appraisers, including the cost, market and income approaches. It provides further guidance on the economic and control rights vested in each security, including voting, drag-along, participation, first refusal, management, conversion, information and liquidation preference rights.

The next step is to create a model that addresses these rights and provides an analytical framework of the interactions between the various shareholders—breakpoints for the liquidation preferences for each security from which a determination of when a shareholder will elect to convert or not convert their security can be developed.

The final step of allocating equity among the various classes of stock under the practice aid is to use one the following methods:

- The probability-weighted expected return method (PWER).
- The option-pricing method.
- Current-value method.

Q. How does development stage impact us under 409A?

A. For start-up companies that issue stock instead of options the reporting requirements of 409A do not apply—however the stock must be valued to report the taxable income received by the person. The value of the stock is determined as of the grant date or within a reasonable period after the valuation date. If new financing, a substantial new customer acquisition, or other events occur, then a new valuation is necessary. Fair market value is the controlling standard of value and the IRS has issued revenue ruling 59-60, which covers privately-owned company valuations. For firms beyond the start-up period but before an IPO or other exit event, you need to meet compliance under one of the three methods described in our first article to meet the **presumption of reasonableness** under 409A:
(continued on page six)

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- Binding formula
 - Illiquid start-up valuation
 - Independent appraisal

Compliance under the binding formula “presumption” is rare because it is so restrictive. For those start-ups beyond the formative stage, the next two presumptive valuation methods will most likely be used. Under the independent appraisal presumption, a qualified independent appraiser values the enterprise using “traditional appraisal methodologies” and it is conducted within the prior twelve-months, assuming that no significant event has occurred.

Meeting the “reasonable” test under the illiquid start-up method is a bit more complex and may serve as an initial strategy as a company evolves. Defined as a company under 10 years old and not within 180 days of an IPO or within 90 days of an acquisition, the illiquid start-up valuation presumption is used if the following requirements are met:

- The valuation is prepared by a person with significant knowledge and experience in performing similar valuations.
- The valuation is evidenced by a written report.
- The valuation considers the general valuation factors in the regulations.
- The company anticipates a public offering management change within twelve months.
- The stock being valued is not subject to any put or call option.

While some founders, board members and/or executives may incorporate the above requirements into a written report, expect your auditors to test your assumptions, methodology and opinions in order to meet the reporting requirements of FASB 123R. Another approach is to retain a valuation firm to assist you with the process. Under either scenario, a valuation report format has not been articulated under 409A. Please note however, that a number of valuation factors must be addressed in the report including the tangible and intangible assets of the company, present value of future cash flows, public trading price or private sale price of comparable companies, the issue of control premiums and discount for lack of marketability.

We have developed a reporting format that may be useful for companies seeking to comply with the illiquid stock presumption which can be obtained by E-mailing me at my address in the contact line. (The suggested format is not a complete appraisal report of FASB 123R.) For firms that have an expectation of an exit event—either in the form of an IPO or merger/acquisition, most companies will be using the independent appraisal presumption.

Q. If Microsoft and Google can, why can't we? With the issue of backdating stock options and the adoption of additional reporting requirements some publicly traded companies began using restricted stock—can we issue restricted stock and avoid 409A?

A. For very early stage companies, restricted stock, either in the form of a direct grant or an unvested grant, may make sense as the stock is not covered by 409A. However, the stock must be priced at fair market value in order to determine the amount of taxable income the recipient will report. For other companies, as the value of the company increases, the grant of restricted stock becomes less viable, because the fair market value of the grant is reportable as taxable income in the year of grant.

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