Valuation of companies and pricing of stock options

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A frequent issue faced by early stage and high growth companies is how to determine the value of the company when granting equity based compensation. This issue is not new to management and boards, but as the accounting and tax rules have continued to focus on the concept of fair value and deferred compensation the issue has become more complicated and with greater potential consequences if determined in a manner deemed inappropriate.

In 2004, the AICPA issued a practice aid titled, "Valuation of Privately-Held-Company Equity Securities Issued as Compensation". This practice aid provides best practices for the valuation of and the disclosures related to the issuance of privately-held-company equity securities as compensation. This practice aid became the standard for how most valuations of private company securities are undertaken by valuation experts and how they should be approached by management.

In January 2005, Section 409A was added to the Internal Revenue Code. Under Section 409A, a stock option having an exercise price less than the fair market value of the common stock determined as of the option grant date constitutes a deferred compensation arrangement. This typically will result in adverse tax consequences for the option recipient and a tax withholding responsibility for the company.

In addition to the adverse tax consequences under Section 409A, management also needs to ensure that a proper valuation is available to support significant transactions impacting its financial statements. In addition to stock based compensation, other equity and debt transactions may also create the need to support the value of the underlying shares to properly reflect such transactions on the company financial statements in accordance with generally accepted accounting principles.

We are often asked "what are the acceptable methods for determining the fair market value of private company stock"? The fair market value of private company stock must be determined, based on the private company's own facts and circumstances, by the application of a reasonable valuation method. A method will not be considered reasonable if it does not take into consideration all available information material to the valuation of the private company.

The factors to be considered under a reasonable valuation method include, as applicable:

- the value of tangible and intangible assets;
- the present value of future cash-flows;
- the readily determinable market value of similar entities engaged in a substantially similar business; and
- other relevant factors such as control premiums or discounts for lack of marketability.

The bottom line is the regulations have significantly changed the method by which a private company determines the fair market value of its stock. For example, valuation of private company stock solely by reference to a ratio related to the value of preferred stock (the old 10 to 1 ratio) generally will not be reasonable.

Most early stage and high growth companies will have to weigh all these factors when considering if and when it should incur the cost of engaging an external valuation firm to determine the fair value of the company or to perform the valuation internally. If the decision is to perform the valuation internally, management and board members will need to ensure that individuals involved in the process satisfy the "significant knowledge and experience" requirement as outlined under Section 409A. Lastly, if engaging a valuation firm it is also advisable to have the qualifications and approach being utilized by the valuation firm reviewed by your audit and tax advisors prior to making a final decision.