



# New Stock Option Rules for Early Stage Companies

Dr. Stanley Jay Feldman, Axiom Valuation Solutions and  
Associate Professor of Finance, Bentley College

Ken Appleby, Foley & Lardner

Jack Malley, First Jensen Group





# Agenda

- I. Overview of Fair Value Changes Relevant for Early Stage Companies
- II. Update on Final 409A Regulations
- III. Valuation of Early Stage Companies for 409A and 123R Expense Calculations
- IV. What is a CFO to Do?



# IV. What is a CFO to Do?

Jack Malley



## What's A CFO To Do?

- Start training for a new career
- Go work for a publicly-held company
- Go work for a one owner company
- Deal with it





## If Your Company Will Be Heading To A Liquidity Event In The Next Few Years, Understand The SEC's Viewpoint

- Valuations are important – don't want to see sharp increases in stock price leading up to IPO, unless there is a valid reason – leads to high comp expense
  - *Some companies have had monthly valuations leading up to IPO!*
- Don't believe that a valuation is not necessary just because your last funding round was flat with the previous round
  - Inside round
  - What happened to the comparables?
- Understand the valuation report and its assumptions
  - Inconsistencies between the nature and stage of development of the company and the selection of appropriate assumptions in the valuation
  - Inappropriate allocation of the enterprise's value to the various classes of debt and equity securities
  - Inappropriate liquidity discounts taken in valuing equity securities
- Read SAB 107 – Interaction of FAS123R w/ SEC Rules



## Dealing With It...

- Review all employment contracts & offer letters
  - Review for deferred compensation awards
  - Ensure that stock compensation award terms are consistent with compensation committee or board of director votes
    - Verifying the grant date is critical
      - Date valid when all ordinary and necessary corporate actions have been taken
      - Grant award should ID who, how many, price, when, vesting
  - Streamline timing of awards
    - Company milestones
    - Salary reviews
- Build a solid cap table
  - Grantee, grant date, #, vesting, exercise Px
  - Marry it to the board minutes



# Get an Appraisal Not Req'd but Provides Safe Harbor

- Get familiar with AICPA Technical Practice Aid and methods prescribed  
**“Valuation of Privately-Held-Company Equity Securities Issued as Compensation”**

## AICPA Practice Aid Recommended Valuation Methods

Stage	Funding	Revenues	Expenses	P&L	R&D	Valuation Method
1	Seed or 1 <sup>st</sup>	None	Limited	Loss	R	Asset-Based
2	2 <sup>nd</sup> or 3 <sup>rd</sup>	None	Substantive	Loss	R&D	Market (primary) Asset-Based (Alternate)
3	Later rounds	None	Substantive	Loss	Late D	Market (primary) Income (Alternate)
4	Mezzanine	Some	Substantive	Loss	Late D	Either Market or Income
5	N/A	Substantive	Substantive	Breakeven	N/A	Either Market or Income
6	N/A	Substantive	Substantive	Profit	N/A	Either Market or Income



# Get an Appraisal

## Not Req'd but Provides Safe Harbor

- Understand Fair Value
  - Meaning of IRS Rev Rul 59-60 “fair market value” is consistent with TPA fair value (TPA pg 7, footnote 8 & pg 81, footnote 1)
- Do it yourself - Do you have sufficient knowledge, experience, and skill? Final IRS Regs say:
  - *“...whether a reasonable individual, upon being apprised of such person’s relevant knowledge, experience, education and training, would reasonably rely on the advice of such person with respect to valuation in deciding whether to accept an offer to purchase or sell the stock being valued.”*
  - *“Significant experience generally means at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the service recipient operates.”*
- Hire an appraisal firm
  - Make sure they follow the TPA
  - Ensure valuation can be used for FAS 123R purposes
  - Provide business plans, historical financials, competitive environment, cap table



## Will Your Appraisal Pass the Audit Test?

- Will the valuation specialist accept responsibility for their report, their conclusion and all underlying assumptions?
- What are the qualifications of the valuation expert?
- Did management provide all necessary information to the valuation expert and was the input utilized?
- Did management review the valuation report?
  - Forecast used
  - Understand probabilities of IPO, M&A, Liquidation and Status Quo
  - Discount and premium rates (industry risk, size of company, etc.)
  - Assumed liquidity dates



## Will Your Appraisal Pass the Audit Test?

- New Risk Assessment Standards, effective years started after 12/15/06, require that auditors:
  - Obtain a greater understanding of an entity and its environment, including internal control and;
  - Perform a more rigorous risk assessment for material misstatements in the financial statements due to fraud or error.
  - Auditors must consider the potential for misstatement, not whether a misstatement has occurred and the reason the internal control system failed to detect misstatements that audit entries are being proposed to correct.
  - Auditors must also consider whether the client is capable of performing the accounting functions and preparing financial statements, *inclusive of notes*, in accordance with generally accepted accounting principles (GAAP) and *has the skills to prevent, detect or correct misstatements*.



# Will Your FAS 123R Calculation Pass the Audit Test?

- Most companies using Black-Scholes-Merton Model vs. Lattice Model
- Cost methods
  - If used minimum value method on pre-2006 grants, then must use the “Prospective” method (§83)
    - Continue minimum value method on pre-2006 awards
    - Use FAS123R method on
      - Post-2005 grants
      - Pre-2006 grants that have been modified, repurchased or cancelled in FY beginning after 12/15/05
  - If used fair value method of FAS123, use either
    - Modified retrospective method (§76)
      - Must adjust prior financials based upon original fair value calculations!
    - Modified prospective method (§74)
      - Book comp expense as old awards vest based upon original grant date fair value calculation



# Will Your FAS 123R Calculation Pass the Audit Test?

- Grant date
  - Mutual understanding between employer & employee (§A77)
  - Past practice is key
- Recognize over requisite service period
  - Usually the straight line over vesting period
  - Cumulative comp exp must at least = cumulative amount vested (§42 and §A97-A104)
- Volatility
  - Comparable public companies (§A43)
  - Industry sector index (§A45 & A46)
  - Look back over term (§A48)
- Term
  - SAB 107 might accept  $(\text{vesting term} + \text{original contract term}) / 2$  (§D, Question 6)
  - E.g., 25% vest each year, 10 year contractual term
    - $(4 \text{ yr} * 25\% + 3 \text{ yr} * 25\% + 2 \text{ yr} * 25\% + 1 \text{ yr} * 25\% + 10) / 2 = 6.25 \text{ years}$
- Pre-Vesting Forfeiture Rate
  - Adjust cumulative affect of rate change each reporting period (§43)



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Associate Professor of Finance, Bentley College  
[stan@axiomvaluation.com](mailto:stan@axiomvaluation.com)

Ken Appleby, Foley & Lardner  
[kappleby@foley.com](mailto:kappleby@foley.com)

Jack Malley, FirstJensenGroup  
[jmalley@firstjensengroup.com](mailto:jmalley@firstjensengroup.com)