

MFA Perspective

Giving Stock Options A Second Look:
The benefits of new grants at low values



MOODY, FAMIGLIETTI & ANDRONICO
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GIVING STOCK OPTIONS A SECOND LOOK: THE BENEFITS OF NEW GRANTS AT LOW VALUES

A confluence of downward trending economic and business events, including the continued decline in stock values during the latter part of 2008 and early 2009, is leading companies to reshape their business plans. Many small and medium size private enterprises face challenges such as continued product development, sales team and channel development, revenue growth, cost containment and related process enhancements. Add to this the difficult compensation market and a hesitant venture capital environment, and C-level executives have their work cut out for them in offering real motivation to their key employees. Payouts and downsizing are hitting most industries, while the need to stay focused on the business will not disappear.

Retaining talent, therefore, is everything: when the profits don't exist to pass on in the way of high compensation, stock options are routinely used to incentivize the employee base and retain key people. With fair values near rock bottom, companies are seizing this opportunity to strategically grant additional options or reprice existing stock options.

However, valuations performed as recently as mid-2008 likely reflect much higher values, so a new valuation may be necessary in order to re-issue and protect the company against negative financial reporting and tax implications. In the long term, the market will most likely rebound and options issued at today's low values will show high yield for fully vested employees. For those not yet vested, the return to value will bring high appeal to staying with and growing the company.

A new valuation also addresses the simple issue of stability. It is worth stating that in addition to the opportunities at hand, there are standard regulatory pressures that apply to stock option valuations. Section 409A of the Internal Revenue Code calls for an annual valuation to provide safe harbor and avoid

tax exposures for deferred compensation. Significant company changes (such as a new round of financing or a new product offering to name a few) trigger the need for an updated valuation report.

Because of 409A's safe harbor clause, external valuations have steadily grown to become the norm. In fact, CFOs should only use an internal valuation if their in-house capabilities have the right expertise. Valuations come into play on too many levels to take a chance, especially when dealing with taxation of deferred compensation, GAAP and audit concerns.

Looking long term, there is much to be gained from acting quickly and decisively on stock option valuations. Despite the challenging economy, companies will survive and flourish; those who take advantage of these historically low prices may see a great deal of upside when the market emerges from its prolonged slump. Strong companies that are led by talented management teams will survive and prosper.

FOR MORE INFORMATION, PLEASE CONTACT:

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