

## **New options-reporting rules would strain small companies**

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By Karen Kerrigan and Joel Jameson

Though the dust has just begun to settle on the Financial Accounting Standards Board's (FASB's) new rule 123R mandating that stock options be reported as accounting expenses, it seems that the other shoe is poised to drop on start-ups and small businesses.

Thanks to new rules, and headlines regarding the "backdating" of stock options, small privately held companies will likely be facing much greater regulatory scrutiny, more extensive enforcement and thus, more costs.

The Internal Revenue Service, apparently emboldened by the standards board's new rule is now finalizing its Rule 409A which, among other things, would require fairly extensive efforts for non-publicly traded companies to perform valuations for the strike prices of their options. The purpose of this rule is to ensure that potential taxes are paid if option strike-prices are different from current share values.

The basic IRS standard for compliance with 409A is "the reasonable application of a reasonable valuation method." The exact details of what valuation methods and principles will be deemed "reasonable" will not be known until perhaps late summer. However, the rule has already created a cottage industry of "valuation specialists" in Silicon Valley. Many small private companies have chosen to pay for specialists rather than face potentially devastating fines, penalties and bad publicity for "unreasonably" undervaluing the exercise price of a stock option grant.

Those companies that choose not to do the valuations face increasing uncertainty in the face of a federal regulatory climate that is becoming highly aggressive. Those performing valuations also face uncertainty because there is no institutional market valuation for non-publicly traded companies. In effect, these specialists are attempting to place a value on a lottery ticket, which for many small companies may end up being an expensive exercise in educated guesswork with no guaranteed safety at the end of the day.

More than 20 companies are currently under federal investigation for options-related activity in Silicon Valley. In the short time that 409A has been on the books, no company has been prosecuted. That may change soon, however, should the federal government widen its inquiry -- placing greater emphasis on smaller, privately held companies. Should headline-grabbing stories like those recently appearing continue to emerge, companies found guilty of options manipulation

could be forced to issue restatements. Officers, rank and file employees and even auditors could face jail time.

No one will dispute that the federal government has an investigative and enforcement role when it comes to stock options. Certain extreme cases aside, the real genesis of the scandals surrounding options are the frailties and loopholes of our current rules-based reporting system. Thanks to this faulty system, and under the aegis of IRS 409A and FASB 123R, it now appears that federal regulators are poised to begin a crusade to make an example out of small, non-publicly traded companies at a time when we should be finding innovative ways to ease the burden on small companies to keep them, and our economy, competitive.

Supporters of small business and venture capital in Congress should question the wisdom of creating more regulatory burdens and overhead costs upon small companies at a time when global competition is fierce. Focusing government resources on hyper-enforcement and new layers of regulation will serve only to create more uncertainty while ensuring full employment for prosecutors, financial consultants and trial attorneys.

Instead, resources should be marshaled toward creating a uniform, safe harbor where non-publicly traded companies can value options using bright lines and sound principles of mathematics and accounting at low cost.

Congress and the Bush administration should make sure that the IRS and FASB look forward, not backward, and protect small business from new burdens such as 409A by working to build a more intelligent framework for all businesses.

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