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MOSS ADAMS SPECIAL REPORT

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I've had numerous discussions recently with CFOs across Southern California, and in many of these talks, one theme dominates: the economy. But not necessarily in a doom-and-gloom way. Yes, many businesses continue to struggle, but CFOs are nevertheless determined to do all they can to strengthen their company's balance sheet, improve its bottom line, find ways to stay ahead of the competition, and grind out the recession until business and the financial markets rebound.

Moss Adams LLP admires this tenacity, and we continue to support CFOs' efforts to help their companies maintain and improve their financial operations. It's in that spirit that we've developed this special report, which looks at four key areas on which CFOs can focus their efforts and drive greater opportunity for themselves, the business owners they work for, and the company itself.

I invite you to share in the collective knowledge Moss Adams has to offer. And as always, I welcome your comments and questions: todd.vanderwel@mossadams.com.

-Todd Van der Wel



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Understanding Your Options: The Return of Stock-Based Compensation

by Jim Van Houten, Senior Manager, Moss Adams

In the current economic climate, it has become increasingly important to find creative and cost-effective ways to retain key employees while maximizing your business's cash flow. One way that's again growing in popularity is the use of stock-based compensation, including stock options, in executive compensation packages.

Stock-based compensation presents an opportunity for a business to offer a competitive pay package, often with less cash compensation up front. It also works well for employees in start-ups, since the future value of the company's stock is likely to be greater than it is today. Couple that with the added incentive to the employee if their hard work can influence the future success of the business (and, in turn, the stock price), and it's a win-win for all involved.

However, the tax laws surrounding stock-based compensation and stock options can be complicated—and often create traps for the unwary. During the height of the stock options craze of the late 1990s and early 2000s, people mortgaged their homes and poured their savings into stock options hoping to get rich quickly, and many were left with nothing more than a worthless stock certificate and a large tax bill.

How can you prevent this from happening to you? The key lies in proper planning combined with understanding the risks associated with your stock-based compensation.

The three most common forms of stock compensation seen in executive compensation

packages are restricted stock, nonqualified stock options, and incentive stock options (ISOs, also known as qualified stock options). Let's compare each of these and their respective tax treatment.

Restricted stock generally takes the form of an outright stock grant that limits the recipient's ability to transfer the stock. The restrictions generally lapse over time according to a vesting schedule. If the recipient leaves the business prior to vesting, then the stock is generally forfeited back to the company.

The receipt of restricted stock isn't a taxable event at the time of the grant. Instead, the value of stock at the time the restrictions lapse determines the amount of taxable income the recipient includes in income. This is generally treated as compensation, and the employer must withhold income and payroll taxes on this income. To do so, some of the shares are typically liquidated at the time the stock vests to cover the taxes. The recipient can make an 83(b) election to include the value of the stock in income at the time of grant. But since there's risk involved in doing this, you should weigh the costs and benefits prior to making this election.

ISOs are options to purchase shares of stock at a certain price with special tax treatment. They're not taxable at the time of grant or at the time of exercise for regular tax purposes. (They are, however, taxable for AMT purposes at the time of exercise.)

If the exercised stock is held for one year from the date of exercise and two years from the date of the grant, the gain is taxed at long-term capital gains rates when the stock is sold. If it's sold before then, the sale is deemed a "disqualifying disposition" and the gain is then taxed at ordinary income tax rates. Careful

planning should be done when determining when to exercise and hold ISOs, especially given the potential AMT tax trap. The potential long-term capital gains rate tax savings can definitely make this planning worthwhile.

Nonqualified stock options are similar to ISOs in that they aren't taxable upon grant. Upon exercise, however, the difference between the fair market value at exercise and the exercise price is taxable as compensation and subject to income and payroll tax withholding. Thus, unless the employee pays the exercise price

upon exercise, it generally makes better sense to simply exercise and sell these options once they reach a value deemed worth selling by the employee. Many companies allow for a cashless exercise, in which the exercise price and taxes can be paid from the proceeds of selling the stock and the employee receives only the net amount left over. Again, planning for these options in advance of exercise will help determine a strategy for success.

The tax laws for stock-based compensation are complex, and there are risks and



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plus the tax withholding, some of the shares will need to be sold at the time of exercise.

Under certain circumstances, it may make sense to exercise and hold nonqualified stock options; however, given the immediate tax hit

rewards inherent in any form of stock-based compensation. If you have options or restricted stock as a part of your compensation package, it's important to develop a strategy and plan ahead with a tax advisor well-versed in the applicable laws.

Business Owner Wealth Management: Why It Matters to CFOs

by Jason Romano, Partner, Moss Adams Wealth Advisors,
and Curtis Abramson and Harold Breslow, Partners,
Moss Adams

For a business to be successful, it needs to develop a strategic plan to provide a road map for success. However, the plan may not be complete unless it considers the goals of the company's owners. These often include such things as maintaining a lifestyle, funding retirement, and achieving financial independence.

One of the ways to link a company's strategic plan with these goals is to develop a comprehensive personal financial plan for each of the owners. The company's CFO can play a key role here. Traditionally, financial planning for business owners looks at three broad categories:

- Tax and estate planning
- Investments and insurance
- Succession planning, ownership transition, and retirement planning

Examining each of these areas helps identify any shortfalls or issues requiring attention.

Business owners often start working with a CPA and an attorney for their tax and basic estate planning needs. However, if they're performed as a stand-alone service, the business owner might not benefit from the holistic approach a comprehensive financial plan typically provides. Decisions are often made without an understanding of how taxes and estate planning affect investments, succession planning, and retirement planning.

As a CFO, you can help guide these decisions with an eye toward a more complete plan. For example, tax and estate planning should be done in the context of an overall plan and with the goal of minimizing taxes—both during life and after death—for the benefit of the business owner's family, philanthropic causes, or a combination of both.

Investments and insurance each also play an important role in any financial plan. Investments take the form of retirement or qualified assets, such as 401(k) plans and IRAs, as well as nonqualified, or after-tax, accounts. Depending on the savings habits of the owner and his or her pre-retirement lifestyle, liquid net worth typically begins to increase after the business enters the mature phase. Care should be paid to the time-tested principles of asset allocation and diversification. Life insurance, typically viewed as a necessary evil, is often ineffective when purchased as a stand-alone product rather than as part of an overall plan. Life insurance, disability insurance, and long-term care insurance should all be evaluated as part of the plan.

Finally, there's succession planning. The transition of ownership and/or management of the business or the ultimate sale of a business often leads to the eventual retirement of the business owner. Typically considered one of the more complex stages of the planning process, this last aspect of the comprehensive financial plan is too often overlooked and generates the most serious issues if not addressed early on.

Business owners and CFOs are too often consumed by the day-to-day operations of their business to address this phase. At the time an owner receives an offer from a prospective buyer or, as in recent years, after a broad economic recession or other significant life event, an adequate plan may not be in place. Succession planning is generally considered the most time-consuming phase of the financial plan, and business owners should expect it to be emotionally difficult, since it often deals with the eventual end of one's life's work.

A financial plan should always be considered an evolving and working document and should be reviewed at least every two years (more frequently if significant changes

occur before that time) by the CFO, the business owner, and his or her advisory team—typically made up of a CPA, a Certified Financial Planner, an attorney, an insurance agent, and an investment advisor, all working collaboratively.

Although developing a comprehensive plan requires significant time and effort, in the long run it can greatly increase the chances of success, helping ease ownership transition and potentially ensuring the continued longevity of the company.

Is Your Company's Life Insurance Policy Helping—or Hurting?

by Aimee Kwain, Senior Insurance Specialist,
Moss Adams Wealth Advisors

Companies often purchase life insurance policies as a means to fund different business arrangements, such as buy-sell arrangements or executive compensation plans. Properly used, insurance can be a powerful tool for these purposes. However, improperly managed, it can precipitate the downfall of a plan.

Here's where you can play a crucial role. As CFO, you oversee everything from budgeting and business financial planning to human resources and IT. You work closely with the owners to chart the future of the company and are familiar with its business plans. As such, you can help ensure the success of these insurance-funded plans by reviewing three things: the life insurance policies, the insurance company, and the agreement.

Business plans funded with universal or variable life policies expose themselves to greater risk. Chances are, these policies are underperforming. And without additional premiums, they'll likely terminate in the near future. Many of these policies projected high rates of return, but in today's economy they simply aren't achieving expected results. Declining interest rates and vulnerable markets place many policies in jeopardy of lapsing or becoming insufficient to support plan designs. Subjecting your company's life insurance portfolio to a performance review is an important and financially sound practice.

You should also review the life insurance company. You want to make sure your policy is placed with a financially secure company. After all, you don't want to worry about whether a life insurance company will be able to pay out the required benefits. In addition, many states put a limit on how much you can recover should a company become insolvent.

A simple review of its Comdex rating reveals the financial stability of an insurance company. A composite of various ratings (from Moody's, Standard & Poor's, A.M. Best, and Fitch) a company has received, the Comdex ranks companies based on a percentile up to 100. The higher the percentile, the more fiscally sound the company. The Comdex rating helps reduce the confusion caused by each rating system's use of a different scale.

Lastly, don't forget to review your agreements. Laws change, and you may not know how these changes affect your plans. Having a qualified person review your agreement can help ensure that life insurance isn't included in the valuation of the business for estate tax purposes, that the buy-sell agreement is aligned with your operating agreements, and that the business plans are in accordance with current tax law. Without a review, not only could the business be exposed to unintended tax consequences but employees or the executives themselves could also be subject to taxation and even penalties.

With a simple review of these key areas, you can anticipate potential challenges life insurance can pose—and help proactively protect the business, its owners, and its employees.

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Putting Your Company's Cash to Work

by Jim Schlager, Partner, Moss Adams Wealth Advisors

The past several years haven't been kind to companies seeking yield or interest on their cash. Ordinarily, businesses can accrue substantial interest when there's a lag between receivables and payables. But banks are paying minimal interest these days, forcing companies to get a bit more creative if they want to maximize the return on their parked cash. CFOs interested in increasing this return might consider three steps:

1. Ensure that you have a solid grasp of your company's cash flows—what's coming in, what's going out, and when.
2. Work with an advisor who also has a solid understanding of your business, including its goals and any tax-related issues it faces.
3. Work with an advisor to structure a laddered corporate or municipal bond portfolio, which may result in higher yields. Ideally, the bond ladder should flow with the rhythm of your company's cash flows, with bonds delivering cash to your account when it's most needed.

Even more creative—and possibly providing some arbitrage—would be to establish a margin arrangement with your corporate bond portfolio. Margin loan rates can be substantially lower than the yields you'd receive on your bonds. If you use a margin arrangement to pay for current cash-flow needs, your bonds can continue to earn higher yields and as the bonds mature, depending on your cash flows, you can decide whether to pay down or pay off the margin or reinvest in higher-yielding bonds.

While using margin provides you with greater buying power, it also increases your exposure to market volatility and could create losses if not properly structured and monitored. This is another reason to work with a trusted and knowledgeable advisor.

There are many institutions willing to negotiate the margin spread (the additional interest rate over the base LIBOR or Federal Reserve funds rate the institution will charge you on your margin). While LIBOR and the Fed funds rate fluctuate, the spread is fixed. Thus, it behooves you to negotiate this now and lock it in while institutions are looking for business.

In the current economy, many CFOs are seeking ways to maximize their company's cash flow. Following these steps could offer you an opportunity to add additional monies while maintaining flexibility and, most important, control.

~~BEING HISTORY~~ MAKING HISTORY.

Economic downturns come and go. But the companies that pay attention to fundamentals tend to outlast them.

Find out what thousands of smart CFOs and company owners already know: that the key to business longevity is working with the right advisor—one who can help you not only solve complex tax and assurance challenges but also build, manage, preserve, and transition wealth.

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