Accept no shortcuts when valuing Employee Stock Options

Employee stock options (ESOs) aren't just for start-ups and high-tech firms anymore. All types of businesses are compensating employees with stock options in lieu of cash bonuses as an effective way for companies to attract and retain key employees.. ESOs not only save on cash, but they also provide an incentive to increase profits and build value.

However, the administrative side of issuing ESOs can be a headache — and sometimes lead to a minefield of IRS and investor inquiries. Even worse, unsuspecting employees may be stuck with tax liabilities if their options are valued incorrectly. Fortunately, valuation professionals can help guide businesses through the ESO minefield.

Why value options?

Stock options give the recipient the right — but not the obligation — to purchase stock at a predetermined "exercise" price within a limited time frame. Obviously, the higher the stock price goes, the more valuable an employee's options become. Although this article focuses on options given to managers and C-level employees, they may also be given to directors, consultants and other service providers.

Valuing ESOs is important for two reasons:

1. Accounting purposes. As options vest, they must be expensed at their fair value on the grant date — not the exercise date — according to Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 718, *Compensation — Stock Compensation* (formerly FASB Statement No. 123R). Usually, a deferred compensation liability also is recorded on the balance sheet, as well as deferred tax items, if applicable.

2. Income tax purposes. Internal Revenue Code (IRC) Section 409A states that employees must pay income taxes, plus a 20% excise tax, on the value of stock options granted "in the money" — if there isn't a substantial risk of forfeiture, and if the options weren't previously included in gross income. Options are in the money if the exercise price is set below the fair market value on the grant date. The tax liability is especially burdensome because employees don't receive any cash from their employers when they're issued ESOs.

In general, as long as the exercise price is at or above the grant-date fair market value and all other 409A requirements are met, an ESO is exempt from Sec. 409A. If exempt, compensation is deferred until the employee exercises the option.

How are options valued?

Valuators using option-pricing models consider the following elements:

- Exercise price,
- Expected term (time until expiration),
- Value of the company's stock on the grant date, and
- Expected stock-price volatility or, for private companies, the expected volatility of a comparable market-pricing index.

All else being equal, higher values are assigned to options with lower exercise prices, longer terms, higher grant-date stock prices and lower volatility. Valuation models also consider the company's expected dividends and the risk-free rate.

The Black-Scholes model is the best-known tool for pricing options. But because it's based on calculus, this model can be hard for auditors, employees, jurors and other laypeople to understand. In addition, the model can't take into account the specific characteristics of private company ESOs, including vesting schedules, transfer restrictions, change-in-control provisions, and suboptimal employee investing behavior. As a result, the Black-Scholes formula tends to overvalue private-company ESOs.

By comparison, binomial and trinomial lattice models can take these limitations into account and generate more reliable, defendable ESO values. Lattice models use simple algebra and can be depicted with intuitive decision trees.

Why does stock price matter?

Some inputs, such as the exercise price and expected term, are relatively straightforward. But stock price is a more ambiguous ingredient when valuing private companies' options, regardless of whether the Black-Scholes or a lattice model is used.

Appraising stock is especially cumbersome when multiple ownership layers exist. And private companies actually issue *new* shares when employees exercise their options, thereby diluting the existing shares. This creates a circular reference in the model, because stock price is an input in the value of stock options. Fortunately, experienced appraisers know how to use spreadsheet formulas as aids in determining the most appropriate value.

The IRS requires companies to determine the fair market value of stock through "the reasonable application of a reasonable valuation method." Acceptable methods for valuing private stock include the cost, market and income approaches, according to FASB and IRS guidance. Other relevant factors, such as discounts for lack of control and marketability, also may be considered.

Who values ESOs?

No matter how experienced, most in-house accounting personnel lack business valuation training and experience using complicated option-pricing models. So, most auditors will ask for a formal outside appraisal report before signing off on their clients' deferred compensation plans.

IRC Sec. 409A doesn't specifically require that an independent appraiser estimate the fair market value of a taxpayer's stock. But valuations made by an independent outside appraiser within 12 months of the grant date generally fall under the Sec. 409A safe harbors. They're afforded a "presumption of reasonableness" and shift the burden to the IRS to prove that the valuation method was "grossly unreasonable." If a company doesn't use an independent appraiser, it will bear the burden of proving its valuation methodology reasonable.

How should you proceed?

ESOs remain a useful tool for attracting and retaining key talent, but businesses should be aware of the accounting and tax requirements involved — and the potential risks that are posed. Reasonable stock and option valuations prepared by independent valuators can limit exposure for employees, plan sponsors and board members.

Contact APEX Financial Services, Inc. at (952) 238-1315 to discuss your particular requirements in confidence.