Accounting, Tax & Valuation Considerations When Issuing Stock Options

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Introduction

When selling your home, it is common to use an agent to list, promote and show the property. In exchange, you pay a portion of the sales price as a commission to the agent. The benefits of using an agent include: 1) the listing of your home in a database so that homebuyers can access information; 2) the agent acting as your middleman during the negotiation process; and 3) the incentive it gives the agent to sell your home quickly (so that her or she can earn their commission).

Some people choose to sell their home by owner and forego using an agent. These are typically the homes that have “For Sale” signs in their yards for many months, sometimes even years (you know the ones), before they are actually sold. These people often believe that the benefit of not having to pay an agent commission on the sale of their home is worth the prolonged period it will likely take to sell the property.

What does the choice of hiring a real estate agent or selling your home by owner have in common with private companies issuing stock options? The strange answer is: Much more than many of us realize.

If you are interested in learning more about the accounting, tax and valuation considerations that need to be addressed when issuing stock options, I invite you to continue reading this e-book.

About the Author

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Sean is a senior manager with Skoda Minotti’s Business Valuation and Litigation Support Group. In this role, he is responsible for the development review and issuance of valuation reports, calculation of value reports, and expert reports under valuation and consulting standards. Sean has assisted a diverse client base in litigated matters, domestic disputes, shareholder disputes, estate and gift tax filings, and financial reporting valuation issues.

Additionally, Sean serves in Skoda Minotti’s Accounting & Auditing department. He is primarily responsible for performing audits, reviews and compilations for companies in a variety of industries.

Sean earned his Master of Business Administration (with honors) from Case Western Reserve University and his Bachelors of Business Administration (with honors) from the University of Notre Dame. He is a member of the American Institute CPAs and the Ohio Society of Certified Public Accountants, the National Association of Certified Valuators and Analysts, and the Center for Principled Family Advocacy. Sean is the recipient of the 2010 Jeffrey R. Salins Report Writing Award, and serves as Chair of the Marketing Committee on the Lake Catholic High School Advisory Board. He is also a member of the AICPA’s ABV Exam Review Task Force and NACVA’s Case Study Peer Review Team and Q&A Review Team.
Stock Option Landscape

More and more private companies are issuing stock options as part of their key employees’ compensation plans. This may be driven by the ideas that: 1) stock options don’t “cost” anything to the company; 2) stock options will positively influence employees’ performance; or 3) since public companies issue stock options, it must be a good idea and private companies should follow suit. Regardless of the motivation, what most private company owners and executives do not realize is that accounting for stock options, for both tax and financial reporting purposes, may actually have an out-of-pocket cost that is greater than the value of the options themselves.

In order to value stock options issued by private companies, there are two major steps that must be undertaken:

1. Determining the value of the company’s equity (which is a key input to valuing a stock option)
2. Determining the value of the stock option

There are not many privately-held companies with the in-house resources or expertise necessary to perform either of the requirements above, both of which are essential in accounting for the issuance of stock options. This often puts accountants in the awkward position of trying to explain to business owners the “unseen” costs and accounting ramifications associated with issuing stock options.

Back to our analogy, hiring a valuation expert to determine the value of stock options is much like hiring a real estate agent to sell your home. A valuation expert is able to perform both of the tasks identified above that are necessary to value the stock options issued by a private company, much like a real estate agent takes care of the necessary steps to sell your home. This work is not free, however, and depending on the complexity of the company and the options issued, the cost to value a private company’s stock options can range in cost from thousands to tens of thousands of dollars. When private companies issue stock options, they often do not consider the “commission” that they will have to pay to a valuation expert to ensure that the options are properly valued. Unlike real estate agent commissions, however, which are based on the sale price of the home, valuation fees are relatively fixed.

Just like selling a home “by owner,” some companies will issue stock options and try to determine the value themselves (or even worse, not value them at all). By not using a real estate agent, homeowners often find themselves making no headway in the sale of their home. Similarly, by not hiring a valuation expert to value the stock options that they have issued, private companies create the risk that their auditors will not sign off on their financial statements. Maybe even more importantly for business owners and employees, unsubstantiated option values leave both companies and their employees in danger of stiff tax consequences.

Let’s talk about the considerations you should take into account when it comes to issuing stock options. Click here for a free consultation.
Accounting & Tax Ramifications of Issuing Stock Options

To give you more perspective, first let us review the accounting treatment for the issuance of stock options (rest easy - this will not be too painful). When stock options are issued, an expense must be recorded based on the value of the option. A stock option’s value is derived from a variety of factors, two of which are the value of the stock as of the date of the option grant and the exercise price of the option (the price at which the option holder can purchase a share of stock). Determining the value of a company’s stock is not difficult when it is publicly traded, but privately-held companies do not have readily available market prices, which necessitates the services of a valuation expert. Unless the option is properly valued, a company cannot correctly record the associated compensation expense. If a company is unable to correctly record the results of its operations, it may find obtaining a clean audit opinion to be a difficult, if not impossible, task.

Now that I have warned you about the headaches that you may encounter on the “accounting” side of issuing stock options, let me further alarm you with the tax ramifications. If a company sets the stock option exercise price lower than the fair market value of its stock on the grant date, the stock option could be deemed to be deferred compensation according to Internal Revenue Code 409A. Under 409A, such deferred compensation would be immediately taxable to the employees receiving the grant and subject to regular income tax rates plus 1%. Perhaps even more distressing, a 20% penalty plus interest would also be triggered. In addition, employers would be responsible for withholding income taxes for employees on these types of option grants, which if not done, could result in additional tax penalties. The immediate taxability, penalty and withholding requirements do not apply when the stock option exercise price is equal to or greater than the fair market value of the company’s stock on the grant date. It is impossible to compare the exercise price of a stock option to the fair market value of a company’s stock unless a valuation of the company’s stock has been performed. In addition, when a valuation has been performed to establish the fair market value of a company’s stock, the burden of proof shifts to the IRS to disprove the appraised value. Therefore, unless there is documentation to support the fair market value of a company’s stock near the option grant date, there could be significant tax issues in addition to the accounting issues alluded to earlier.
Practical Considerations When Issuing Stock Options

As discussed previously, there are significant risks that a company brings upon itself if it decides to issue stock options without properly valuing the options and the equity of the company. Rather than issuing stock options, if a company wants to offer an employee the opportunity to obtain an ownership interest, the most efficient and “clean” method may be to allow the employee to purchase shares from the company or from existing owners. There is no valuation requirement in this case (unless a party wants to hire an expert to ensure that they the transaction price is fair and reasonable) which also eliminates the out-of-pocket cost for the employer. In fact, a business actually recognizes a cash inflow when an employee purchases shares directly from the company.

I am a valuation expert and I directly benefit from work associated with the valuation of stock options, so why am I telling you to consider alternative routes of compensation? Too often, the companies that issue stock options without having them professionally valued are the same companies that will fight against having their options valued at all due to the cost associated with the valuation. I simply want to spread awareness that there are other avenues of compensating employees and giving them opportunities for equity ownership that may be more cost efficient for companies that are under the illusion that issuing stock options does not require a cash outlay.

If you take anything away from this article, remember that issuing stock options is not a “cashless” expense. Consider that there are other alternatives for compensating employees other than using stock options. Remember that there are transaction costs associated with issuing stock options, specifically, hiring a valuation expert, that will create real out-of-pocket cost for any company. Unless you are ready to comply with the valuation requirements associated with issuing stock options, you may be better off simply not using them and compensating employees in another manner.
The Backsolve Method & Sherlock Holmes

I recently watched the Sherlock Holmes movie with Robert Downey, Jr. (I realize that this is a few years old, but I hadn’t gotten around to seeing it yet). Holmes was a master of using the information around him to solve the puzzles that confronted him. This same approach is taken by valuation experts in the valuation of companies, particularly through the application of the backsolve method of valuation.

The Backsolve Method is a valuation approach that can be used to determine the value of common shares for companies with complex capital structures in which there have not been any recent transactions involving common shares. It considers the most recent price paid for an investment in preferred shares and uses this information to place a value on the common shares. This is particularly important when setting the strike prices of stock options issued by such companies.

The backsolve method was given some attention in the AICPA’s 2004 Practice Aid - valuation of Privately-Held Company Equity Securities Issued as Compensation. The method has continued to gain acceptance from both valuation experts and auditors over time and the AICPA’s 2011 Working Draft of Revisions to the 2004 Practice Aid devoted significant attention to the Backsolve Method.

From a very high level, the Backsolve Method utilizes the Black-Scholes option model to allocate the value of a company implied by recent preferred stock investments between the preferred shareholders and common shareholders. “Breakpoints” are set based on the terms and provisions of the preferred and common stock, which allow for the allocation of value between the various share classes.

The Backsolve Method can be a very helpful tool in valuing early stage companies without much operating history. It can provide a reliable indication of the value of a company’s common shares even when the only recent investments have been in preferred shares. Therefore, the use of this method is becoming increasingly prevalent in setting the strike price of stock options for early stage companies with preferred stock investments.