

Alert

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Consider Total Cost Ramifications When Issuing Stock Options

“Different terms and conditions can affect both the timing and magnitude of option expense.”

Over the years, we have assisted numerous clients with the valuation of stock options and restricted stock. We have found in the course of our engagements that companies often don't understand upfront the overall costs of issuing share-based compensation. Different terms and conditions can affect both the timing and magnitude of option expense. The frequency of grants can increase both the valuation costs and the accounting effort to comply with SFAS 123(R). Compensation committees can do a better job aligning the costs and benefits of their share-based compensation plans by understanding how specific grants will affect the P & L over time. Issues a compensation committee should address include the following:

1. ACCOUNTING TREATMENT

Will the awards be classified as equity or liabilities? Equity awards are valued at the grant date, while liability awards are valued at each reporting date.

2. CONTRACTUAL TERM

Most option awards have a 10-year contractual term, but only a handful of employees hold their options for much longer than the vesting life. One factor to consider is whether grants should have various terms for different employee levels. Shorter option terms can reduce option expense without being generally perceived as having less value.

3. VESTING CONDITIONS

Service and performance conditions are the most common vesting conditions. Options are expensed only when the conditions are met.

Performance conditions are usually based on annual targets (e.g., revenues, EBITDA) to be met over a period of some years. If the targets are set at the outset for the entire vesting period, then the options can be valued at the grant date. But if the targets are to be set annually, the options must be valued each time a target is set. Further, if the performance is tied to the underlying value of the company, then the condition is actually a market condition.

Market condition awards vest based on the achievement of a target share price (or total equity value). They are expensed whether or not the price (or equity value) condition is met.

Depending on the relationship between the company's current value and the target value, the expense may be very large and would need to be taken over a short period of time (if the targets are set too close to the current value and/or the company's volatility is very high), or may be small and could be expensed over a long period of time (if the targets are set far from the current value and/or the company's volatility is very low). In either case the valuation of a market condition option is generally a costlier undertaking than the valuation of options with performance or service conditions because it almost always requires Monte Carlo simulation in a customized model.

continued on back...

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We have a number of clients whose boards have issued a market condition award to only one or two senior executives, for a small number of shares, only to be surprised by the high ratio of valuation expense to compensation expense.

“We recommend consulting with a valuation expert prior to making new types of share-based grants, or restructuring existing compensation schemes.”

4. MODIFYING STOCK OPTIONS

We have been involved in engagements where the client re-issues existing stock options with a lower strike price. What companies often do not realize is that this modification requires that the stock options, and possibly the underlying shares, would need to be revalued. It also increases stock option expense in the income statement.

5. TIMING OF OPTION AWARDS

Another issue that can have ramifications, particularly for privately-held companies, occurs when a company grants stock options randomly throughout the year, i.e. not at a single annual grant date. Even for a closely-held firm which has its shares valued annually, if there has been a significant company, market or industry event which impacts the company's value it may need to commission one or more additional stock valuations. We recommend that closely-held companies issue share-based compensation in connection with annual or other periodic share valuations.

6. RESTRICTED STOCK

According to SFAS 123(R), nonvested shares granted to employees generally are referred to as restricted shares. Under SFAS 123(R), restricted shares are expensed when vested at their fair value on the grant date. Private companies may need a share valuation as of the grant date. If the shares vest based on a market condition, they will also need a valuation of the specific grant which takes into account not only the share value on the grant date, but the possibility of the future vesting and value of the shares in the future.

RELY ON THE EXPERTS

The total cost of share-based compensation can and should be understood by compensation committees. We recommend consulting with a valuation expert prior to making new types of share-based grants, or restructuring existing compensation schemes. The valuation professionals at VRC have extensive experience valuing various forms of share-based payment. For more information contact your Valuation Research representative or Summer Parrish at 609-243-7009. **VR**



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