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# Equity Based Compensation: Balancing Finances and Talent

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Recruiting and retaining talent can be an expensive enterprise. Not all fast-growing companies can afford traditional employee packages, but there may be other options that can meet their needs.

Many C-suite executives at early-stage or fast-growing companies with limited financial resources face the difficult decision of how to adequately compensate their top employees. One solution is equity-based compensation, which comes in many forms including stock options, restricted stock and stock appreciation rights. This causes no immediate cash impact, while providing an employee with ownership, an enhanced commitment to the company and an incentive to grow with the company while sharing in its success. However, the administrative and financial statement impact of issuing such equity-based compensation is often overlooked.

**Stock options** are contractual agreements which provide employees the ability to purchase stock at a fixed strike price through the expiration date. They may be exercised once they are vested, which can be based on the number of years of service or other performance-based milestones. Further, there are two types: incentive stock options ("ISO") and non-qualified stock options ("NSO"), each with advantages and disadvantages for the grantee from a tax perspective.

**Restricted stock** entitles the employee to receive stock in the company once they achieve certain vesting conditions, such as years of service, product milestones or financial targets. When the restricted stock vests, it automatically converts to fully transferable shares of stock in the company.

**Stock appreciation rights ("SAR")** provide an employee with the right to receive stock or cash based on an increase in value of the company's stock. It can also be based on the company achieving a triggering event, such as successfully raising capital, or a liquidation event.

While equity based compensation provides companies with non-cash alternatives to rewarding their people, these options can be burdensome from an administration and recordkeeping perspective. A formal compensation plan should be established along with an agreement which outline the specifics of the equity based compensation awards. This typically requires the involvement of the company's legal counsel and the plan needs to be adopted by the board of directors. In conjunction with this, stock is allocated and, if needed, authorized for inclusion in the plan, which may require an amendment to the company's organization documents. Grantees should be provided copies of the plan agreement and fully executed documentation for the equity based compensation they received.

Equity based compensation may add a further layer of complexity to the company's capitalization table and will require the maintenance of a detailed history of all stock awards granted, exercised and forfeited. Generally, equity based compensation will dilute existing shareholders' ownership percentages in the company, unless existing shareholders are holding a different

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class of stock with preferential treatment upon liquidation. A company will also be required to determine the fair market value of their stock, whether for the purpose of determining the strike price of an option or the compensation expense to be reflected in a U.S. GAAP financial statement. In a non-public environment this can prove difficult and costly, particularly if outside valuation experts are consulted. Valuation methodologies such as multiple benchmarking or discounted cash flows are acceptable. To determine the fair value of stock options the Black-Scholes pricing model is commonly used, requiring the following inputs:

- *Exercise or Strike Price* – Price at which the option owner can purchase the underlying security.
- *Fair Value* – The amount at which the underlying stock could be bought or sold in a transaction between willing parties, other than a forced liquidation sale.
- *Expected Life* – Expected period during which the holder is to perform service in exchange for the option, which is based on historical data.
- *Volatility* – Measure of the amount by which a price has fluctuated (historical) or is expected to fluctuate during a period (calculated value).

The two most difficult inputs for non-public companies are determining the fair value and volatility of the stock. A commonly used approach to determine volatility is to find comparable publicly traded companies that are in a similar industry at a relatively comparable size and obtain the volatility of these benchmark companies' stock to use in the pricing model.

Compensation expense, equal to the fair value of the equity-based compensation, is generally recognized over the grantee's performance period. The recognition of equity-based compensation will typically increase financial statement audit fees due to additional required procedures performed on the stock's fair value calculations, footnote disclosures, and review of the relevant agreements.

Many C suite executives use equity-based compensation to balance their capital resources and talent pool. However, there are related compliance and administrative considerations to keep in mind when making this choice. If used properly, equity based compensation can be a winning strategy leading to great economic success for the company in the present and future.

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