

Stock Based Compensation (ASC 718)

MAXIMIZING VALUE THROUGH KNOWLEDGE™

Option pricing models estimate what an option would sell for in the market today (i.e., its fair market value) given the terms of the option and the underlying stock characteristics, including future expectations. The marketplace sets the value of publicly-traded stock, so the value of options to buy this stock can be readily calculated. However, if the company is closely held, stock compensation raises a valuation issue. First, the company's value must be determined by performing detailed financial analysis of the company and of comparable publicly traded companies. Second, the value attributable to the option must be determined.

Traditionally, the Black-Scholes model is the preferred method for determining the value of an option for financial reporting and taxation purposes. The main assumption underlying the Black-Scholes model is that the underlying stock behaves in such a way that future price changes can be modeled by a probability distribution. These modeled future values, along with other variables, are then used to determine the option's estimated fair market value. These variables include the:

- Underlying stock's value
- Exercise price of the option
- Underlying stock price volatility
- Dividend expected
- Risk-free interest rate for the option term remaining
- Time until expiration (or the expected life) of the options

For companies with complex capital structures, including multiple rounds of preferred stock, warrants for preferred stock, and common stock options, the determination of the common stock value is a complicated task. Adams Capital considers and applies the Current Value Method, the Option-Pricing Allocation Method, and the Probability Weighted Expected Return Method where appropriate.

Stock option valuations are complex problems requiring critical expert decisions. Every situation is unique, so every valuation should be treated with a fresh perspective using the latest market data. Adams Capital has the experience and credentials to make defensible assertions on the value of any type of stock option or bonus share.