Impact of Expensing Stock Options on Small Business

In response to stock option abuses highlighted by the Enron scandal, the Financial Accounting Standards Board (FASB) revised the accounting rules regarding the expensing of stock compensation (FASB Statement 123(R)) in an effort to lend a greater transparency to corporate capital transactions. While businesses were previously required to disclose stock-based compensation, they were not required to expense it. Under this revised statement, all businesses are required to expense stock compensation, resulting in a negative impact on their income statements (P&L). For small business, particularly start-ups, the negative effect can be severe with a direct impact on their economic viability. This seemingly small change in regulation has made it increasingly difficult for small businesses to raise capital and secure funding, thus preventing start-ups and attributing to small business failures.

Before the 1970s, bank loans were a primary funding source for start-up businesses. Due to the economic backslides that followed and in an attempt to safeguard the financial security of the nation, bank lending practices became more tightly regulated under the FDIC. An unfortunate byproduct of this evolution in policy resulted in banks no longer being able to loan money to new, emerging, unprofitable companies. While private investors known as "angels" had always played a role in start-up financing, they quickly became one of the very few options left for the budding entrepreneur. "Angels" usually come in the form of wealthy individuals wanting to invest in a promising new venture. While angels have the funds needed to finance start-up companies, they often lack a deep expertise in finance and accounting rules that the banks are well versed in. This leads to a fundamental problem. While the angel investor may have an understanding of the vision of a company and a basic understanding of the business plans, they cannot help but focus on the tangible: i.e.: the "bottom line."

Even with funding from angels, small companies and startups often lack the funds needed to attract the best and brightest employees to join their teams. These innovative companies need to issue sizable stock options to these employees to compensate their often minimal monetary pay. While the burden upon larger companies when reporting stock based compensation as an expense may be minimal, this can be detrimental to the bottom line of a startup or small business as stock options can inflate a net loss. This, in turn, is directly injurious to the ability of small businesses and start-ups to obtain capital investments from angels. Furthermore, while some companies may manage to attract angel funds in spite of the inflated loss, they are forced to reduce their valuation and offer the investor a greater portion of the company in exchange for their funding.

Despite this change in the classification of stock option compensation as an expense, the IRS will not recognize this as a deductible expense for tax purposes. So even though stock options are now required to be recorded as an expense on the "books", businesses still cannot use this to offset taxable income in profitable years.

Some of the small business start-ups from the era prior to bank regulatory changes have become very successful, maturing into multi-billion dollar enterprises such as Thermo Electron, now Thermo Fisher-Scientific (NYS:TMO). Approximately 60% of new job creation is from start-up businesses. The mature Thermo Fisher-Scientific currently employs approximately 37,000 people and another 15,000 from spin outs. Under the current conditions, many companies such as Thermo Electron would not have been successful due to lack of hypothetical early stage funding.

It is clear that steps need to be taken to help safeguard society from the exceptional greed of some individuals in business. However, what might be a wise course of action with reference to a large business can be toxic for a much less mature and smaller counterpart. It has been recognized by the US Congress that the reporting of stock-based compensation as an expense may have some undue and severely negative effects upon small businesses. In 2004, a special committee was called by Congress to study the possible impact of FAS123(R) on the nation's budding businesses. A panel of experts both favoring and opposing the wide sweeping nature of this revised policy was involved. At the conclusion of the meetings, Congressman Enzi continued to express a great concern for small businesses and their ability to survive after this change in policy. The congressman acknowledged that for small businesses and start-ups to become viable, they need to be able to gain early stage funding as well as attract skilled personnel. He realized that what may seem to be only a simple accounting nuance, could lead to the detriment and death of many small businesses and start-ups which otherwise might have added to the richness of the American economy.

Simple though it may be, a possible solution to this conundrum involving increasing visibility into the workings of corporate capital finance, while not unnecessarily discouraging critically needed investments by lay-investors in small businesses and start-ups is for the FASB to simply differentiate between big business and small, as has been done with Sarbanes-Oxley compliance. In doing so, it ought to be further delineated that the smaller businesses, dependent upon the funding of angels, not be required to expense the stock options used to entice the employees upon which the success of the company is dependent. All companies are required to report stock-based compensation. However, making it part of the "bottom line" makes the early stages of emerging businesses seem exceptionally unprofitable thus causing an instinctual apprehension in angel investors looking into promising new ventures. Limiting the application of FAS123(R) to large business answers to both the need for protection of national finance as well as the promotion of small business and start-up growth.