

What Does It Mean for Your Organization?

FAS 123(R)

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On Dec. 16, 2004, the Financial Accounting Standards Board (FASB) issued its long-awaited accounting standard for stock-based compensation, *Statement of Financial Accounting Standards No. 123 (revised 2004): Share-Based Payment*. For most public companies, this new standard requires expensing of employee stock options for annual and quarterly periods beginning after June 15, 2005. This means that calendar-year companies will have to start expensing stock options in the third quarter of 2005, including an earnings charge for unvested grants made in earlier periods.

During the past several months, FASB has responded to many of its constituents and changed a number of the provisions in its March 2004 Exposure Draft. This article highlights the key features and implications of the final standard, FAS 123(R) (“R” for “revised”).

Key Features of the New Standard

Option Valuation Methods

In contrast to the Exposure Draft, which designated a lattice-type (binomial) model as the preferred method, FAS 123(R) does not specify a preference for any particular type of option-pricing model. It designates the Black-Scholes-Merton, lattice and Monte Carlo simulation models as acceptable (but not exclusive) alternatives. This change gives companies more flexibility in selecting an option-pricing

model. (Also, for the first time, nonpublic companies will be required to use the same option valuation method as public companies.)

Whatever the model, companies must incorporate six standard assumptions, including an option’s “expected term.” This requires analysis of historical exercise patterns, where available, to estimate the likelihood and timing of exercise, cancellation or expiration during an option’s life.

ESPPs

The new standard is similar to FAS 123 in requiring companies to record an earnings charge for an employee stock purchase plan (ESPP) unless the plan meets certain criteria. To avoid an earnings charge, the purchase discount must not exceed the transaction cost to the company in a public offering — with a 5-percent discount safe harbor. The FAS 123(R) rules are an improvement from the Exposure Draft, under which virtually all ESPPs would

have triggered an earnings charge. But they’re less favorable than APB 25, which treats all plans meeting the requirements of Internal Revenue Code Section 423 as noncompensatory.

Performance Awards

“Fixed” accounting treatment will apply to most performance-based plans, just as it does to service-based plans. Key features depend on the type of award:

QUICK LOOK

- Calendar-year companies will have to start expensing stock options in the third quarter of 2005, including an earnings charge for unvested grants made in earlier periods.
- In contrast to the Exposure Draft, which designated a lattice-type (binomial) model as the preferred method, FAS 123(R) does not specify a preference for any particular type of option-pricing model.
- FAS 123(R) does not require companies to “front load” recognition of the cost of an award with a graded vesting schedule.

- **Service-based vesting awards** — Fair value is measured on the grant date, with a “true-up” of total compensation expense at the end of the vesting period based on the number of awards that actually vest. Previously recognized expense can be reversed for awards that don’t vest.
- **Performance-based awards with nonstock-price goals** — As with service-based grants, the cost of these awards, which tie vesting or the number of shares earned to return on equity, earnings per share or other financial or operating measures, is measured at the grant date and ultimately trueed up.
- **Performance-based awards with stock price goals (“market-based”)** — Cost is fixed at grant, but no true-up of expense is permitted, even if the performance goals are missed. But the probability of meeting the goals may reduce the award’s grant date fair value. This treatment applies to awards with stock price or total shareholder return (TSR) goals that are either absolute (meet a grantor-specified share price) or relative (beat an index or a peer group’s TSR).

Period for Recognizing Cost

FAS 123(R) requires recognition of compensation cost over the requisite service period; for most conventional awards, this period is the same as the vesting period. But for performance-based awards, determining the requisite service period may be more complicated. An estimate of when the vesting and exercisability conditions are likely to be met is now required, except in the case of market-based awards, in which the requisite service period is derived from a valuation model. Additional issues arise if multiple goals must be satisfied as a prerequisite to vesting or exercisability, or if there are “either/or” goals.

Graded Vesting

In a welcome departure from the Exposure Draft, FAS 123(R) does not require companies to “front load”

recognition of the cost of an award with a graded vesting schedule. Companies are permitted to recognize an earnings charge for graded vesting awards using either a front-loaded or straight-line method. One catch — this choice applies only to awards with graded vesting based solely on service.

Repricing Underwater Options and Other Modifications

When a company reprices an employee stock option or makes other modifications that increase the value of an award, it will now have to recognize the additional “incremental value” of the award, the difference in fair value between the award immediately before and immediately after the modification, plus any unrecognized cost remaining from the original grant. In many cases, the new standard allows companies to place a higher “before” value on the award than under FAS 123, enabling them to provide more replacement value to employees without incurring an additional earnings charge.

Companies will not have to wait six months between canceling an underwater employee stock option and granting a new one, a feature under APB 25.

Accounting for Income Tax Benefits

The new standard preserves an aspect of FAS 123 that may appear arcane to most observers: parallel treatment of income tax benefit shortfalls and excesses.

Specifically, excess tax benefits arising from equity-based compensation (where the actual income tax deduction exceeds the cost recognized for accounting purposes) is recorded in paid-in capital, a balance sheet account. And tax benefit shortfalls (where the actual income tax deduction is less than the cost recognized for accounting purposes) may also be recorded in paid-in capital, as long as there are adequate balances in that account resulting from recognition

of excess tax benefits from previous equity-based compensation. Otherwise, tax benefit shortfalls must be recorded as an earnings charge. The Exposure Draft would have required companies to record an earnings charge for tax benefit shortfalls, regardless of whether there were adequate balances in paid-in capital.

Effective Date and Transition

The effective date and transition rules vary, depending on whether the entity is a public company, a “small business issuer” or a nonpublic company.

Public Companies

For public companies (except those that file reports with the U.S. Securities and Exchange Commission (SEC) as “small business issuers”), the new standard will become effective for fiscal periods beginning after June 15, 2005. Small business issuers need not comply with the new standard until fiscal periods beginning after Dec. 15, 2005.

The “modified prospective” transition rules that apply to public companies require that:

- Awards granted, modified, repurchased or canceled in periods beginning after the effective date must be accounted for under the new standard.
- Awards granted before, and still unvested at, the effective date must be measured and recognized using FAS 123 fair value accounting, as disclosed in the company’s financial statement footnotes or recorded in the actual financial statements from earlier periods.

Because of the awkward mid-year effective date, companies are permitted but not required to restate earlier fiscal quarters in the year of adoption. Alternatively, they may restate all prior years presented in their financial statements. Companies that choose to restate their financial results will do so using a “modified retrospective” approach. This means that previously granted

options will not be revalued using the new standard. Instead, for the restated periods, the FAS 123 pro forma values disclosed in the company's financial statement footnotes will become the "real" (restated) figures.

Nonpublic Companies

Nonpublic companies benefit from a later effective date: fiscal years (not interim periods) beginning after Dec. 15, 2005. The transition rules for most nonpublic companies are also more favorable.

Nonpublic companies that have not followed FAS 123's "fair value" accounting method for either recognition or disclosure purposes must use a "prospective" transition approach: only awards granted, modified, repurchased or canceled in fiscal years beginning after Dec. 15, 2005, must be accounted for under FAS 123(R); no expense is recognized for earlier grants. Most nonpublic companies are likely to fall into this category, since most have taken advantage of the FAS 123 provision that permits nonpublic companies to value their stock options using a "minimum value" method — in effect, an option pricing model with a zero volatility assumption. FASB does not consider this a "fair value" method, so these companies will enjoy the benefit of the later effective date.

Nonpublic companies that have followed FAS 123 fair value accounting must use the same transition rules as public companies.

Design and Implementation Considerations

Many companies have already made changes to their equity compensation programs in response to fair value expensing because they either have already adopted FAS 123 or were anticipating FAS 123(R).

As companies and their advisers examine the implications of the new standard, there are several plan design and implementation considerations:

Binomial or Black-Scholes Model?

Many companies have been comparing potential costs under various types of option-pricing models to determine whether one is preferable to another. Frequently, the costs derived using a binomial model are lower than under a Black-Scholes model. But companies need to recognize that once they adopt a valuation approach, they generally cannot change to a different one for subsequent awards unless it provides a more precise estimate or there is a significant change in plan design.

Companies should be aware that use of a binomial option-pricing model requires extensive data gathering to develop appropriate assumptions. Before undertaking this time-consuming task, it is advisable to perform a sensitivity analysis to determine the potential cost impact of alternative sets of assumptions under the binomial and Black-Scholes models.

Attribution Method or the Valuation Approach

Companies that grant options with graded vesting schedules have a choice of attribution methods (straight-line or front-loaded). They also have a choice of valuing their options as a single award or a series of awards, with each vesting segment valued separately. The single valuation approach is less complex, but the separate valuation approach results in a lower expense and may be worth the additional implementation costs. Both the attribution method and the valuation approach are accounting policy decisions that must be applied consistently to all plans with graded vesting.

Converting Options to Restricted Stock

A clear trend in the market is the grant of fewer employee stock options and more restricted shares. In setting grant guidelines, the ratio of options to restricted shares should be based on a combination of accounting cost consid-

erations and value perceived by employees. The most common ratios are three or four options to one restricted share, but some companies are using higher ratios — for example, 5-to-1.

ESPPs Phasing Out?

These plans are the most notable victim of FAS 123(R). The traditional ESPP with a "look-back" pricing formula (employees buy at 85 percent of the lower of the company's stock price at the beginning or end of the plan offering period) is costly under the new standard and is being phased out by some companies. In some cases, a flat 15-percent discount on the value of the company's stock on the purchase date is replacing the look-back feature, although other companies have chosen to eliminate their ESPPs entirely. Few companies are likely to redesign their plans to take advantage of FAS 123(R)'s 5-percent discount safe harbor, given that it's a meager inducement to purchase.

Financial and/or Market Performance Measures

Creativity is being introduced into some companies' compensation plans as a result of the new level playing field offered by fair-value expensing. Companies are experimenting with different combinations of performance measures (financial and market) to arrive at plans that best meet their objectives of driving and rewarding behavior that creates shareholder value. As these plan designs become more complex, the accounting treatment becomes less straightforward and should be confirmed with auditors before proceeding too far.

Choice of Equity Instruments

Giving employees a choice of equity instruments is an increasingly popular approach to equity pay. For example, employees can choose a combination of

options and restricted shares according to their own financial and risk profiles. Among the issues associated with this approach are selecting the right conversion or exchange ratio, determining how much flexibility to give employees (for example, offer a choice of 100 percent of equity pay or just a portion of it), higher communication and administration costs, and possible behavioral issues associated with employees having different career-related time horizons and risk preferences.

Stock-Settled SARs

For the past year, stock appreciation rights (SARs) settled in shares have been touted by some as the ideal alternative to employee stock options. Stock-settled SARs provide most of the same benefits as stock options but use fewer shares. FAS 123 and FAS 123(R) allow companies to grant stock-settled SARs with a fixed accounting cost similar to that for options, in contrast to SARs' variable treatment under APB 25.

The recently enacted nonqualified deferred compensation tax law appeared to have put a damper on SARs in the United States. But newly issued Internal Revenue Service (IRS) guidance suggests that many companies will be able to continue to offer their employees stock-settled SARs without adverse tax consequences.

Restatement of Financials

As companies consider the impact of the new standard on their 2005 financial statements, many will view the inconsistent accounting treatment between the first two and last two quarters resulting from the midyear effective date as problematic. Restatement of the first two quarters as of July 1, 2005, is a possibility, but many companies are considering making a "clean break" and adopting the new standard in the beginning of their 2005 fiscal year. To enhance comparability, some will follow

the modified retrospective method and restate all prior years presented.

To make this decision, companies are evaluating the potential cost impact of restatement, early adoption or simply following the mandatory effective date.

Transition Issues


Public companies should consider steps to minimize the cost of applying FAS 123(R) to awards outstanding but unvested as of the effective date. Most have already valued and disclosed or expensed their equity grants for 2004 under FAS 123, but there are still some potential opportunities for cost savings.

• **Accelerate vesting of underwater options** — Because only unvested employee stock options outstanding as of the effective date have to be expensed, companies using APB 25 that have underwater options may wish to vest them fully before the FAS 123(R) effective date.

Although acceleration of vesting triggers a new measurement date under APB 25, the intrinsic value of the underwater options is zero, so no earnings charge would be required. But any such acceleration should be considered in light of employee-retention issues, potential windfalls and shareholder relations.

• **Postpone repricing, accelerate other modifications** — Because the APB 25 six-month "hold" on repricing does not exist under the new standard, companies may wish to postpone any contemplated cancellation of underwater options and granting of replacement options until after the effective date. But other modifications, for example, an extension of the post-termination exercise period, may be less costly under both APB 25 and FAS 123 than under the new standard and might be advisable before the FAS 123(R) effective date. Unfortunately, there is no "bright-line" rule. Each modification

should be evaluated separately.

• **Disclosure** — Under FAS 123(R), companies are expected to disclose information on fair value calculations, including the assumptions used to value employee stock options. Companies that use a range of volatility or dividend assumptions over the option's term should disclose the range and weighted average. This may present a problem for companies that are considering changing their dividend policy, for example, and are concerned about disclosing it prematurely. 

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FIGURE 1: **Effective Dates and Transition Rules**

| | Definition | Effective dates | Transition rules |
|--|---|--|---|
| Public company | Has equity securities traded in public market, files in preparation for equity sale in public market or is controlled by a company that meets both criteria | Interim and annual periods beginning after June 15, 2005 | Modified prospective required; modified retrospective permitted |
| Small-business issues | Generally, a public company with revenue of less than \$25 million | Interim and annual periods beginning after Dec. 15, 2005 | Modified prospective required; modified retrospective permitted |
| Nonpublic company that followed FAS 123 fair value principles | Is not a public company and has valued options using full option-pricing model (not minimum value method) | Fiscal years beginning after Dec. 15, 2005 | Modified prospective required; modified retrospective permitted |
| Nonpublic company that did not follow FAS 123 fair value principles | Is not a public company and has not valued options using the full-option pricing model (used minimum value or other method instead) | Fiscal years beginning after Dec. 15, 2005 | Prospective |

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