

## Stock Option Expensing: Final Accounting Rules for Share-Based Payments

### Introduction

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued its final standard ("FAS 123(R)") relating to "share-based payments." Share-based payments include stock options, restricted stock, stock appreciation rights, performance shares, employee stock purchase plans, and the like. Note: As with prior Alerts on accounting issues, this Alert does not provide a comprehensive analysis of the FASB standard, and readers should seek advice from their accounting professionals on these issues. While FAS 123(R) covers a variety of share-based payments, this Alert will focus primarily on the impact to employee stock option grants.

### What is the impact of FAS 123(R)?

Under FAS 123(R), companies will be required to recognize the fair value of stock option grants as a compensation cost in their financial statements. Companies will no longer be permitted to avoid the expensing of standard stock option grants under Accounting Principles Board Opinion No. 25 (APB 25).

### When does FAS 123(R) become effective?

Generally, FAS 123(R) will be effective with respect to stock options that are granted, modified or settled: (1) in fiscal periods (including both interim and annual periods) beginning after June 15, 2005 for public companies (and non-public companies that have voluntarily adopted FAS 123) and

(2) in fiscal years beginning after December 15, 2005 for non-public companies that have not voluntarily adopted FAS 123.

### Will companies be required to recognize a charge for outstanding unvested awards?

Yes, under FAS 123(R), each public company will be required to recognize a compensation cost with respect to any unvested stock options outstanding on July 1, 2005, equal to the grant date fair value of those options (as previously disclosed in the footnotes to the company's financial statements).

### How is an option's fair value determined?

FAS 123(R) does not mandate the use of any particular valuation model. However, it requires the use of a model that is based on the following inputs: (1) exercise price; (2) expected term; (3) current fair market value of the underlying stock; (4) expected volatility of the underlying stock; (5) expected dividends; and (6) risk-free interest rate(s) for the award's expected life.

### Impact on Traditional Stock Compensation Practices

### How does FAS 123(R) treat time-vested stock options?

With respect to stock options granted after the effective date of the new standard, the option's fair value will be measured at the date of grant and will be recognized as a compensation cost over the vesting period.

Unlike the exposure draft, which would have required companies to account for options that vest in equal installments as separate grants with individual vesting periods (thus front loading the compensation expense), FAS 123(R) provides that the compensation cost may be recognized ratably over the vesting life.

### How will performance-vested options be accounted for under the new standard?

While operating under APB 25, many companies avoided strict performance-vested options because they would result in variable award accounting (*i.e.*, at each reporting date, the company would "mark-to-market" and record a compensation cost equal to any increase in the excess of the fair market value of the underlying stock over the exercise price of the option) until the performance goal was achieved or not.

### Key Attorney Contacts

Dan Meehan	720/566-4061 dmeehan@cooley.com
Buff Miller	650/843-5351 bmiller@cooley.com
Dave Walsh	703/456-8021 dwalsh@cooley.com
Thomas Welk	858/550-6016 twelk@cooley.com

This information is a general description of the law and is not intended to provide specific legal advice.

Copyright © 2004 Cooley Godward LLP, 3000 El Camino Real, Palo Alto, CA 94306. Permission is granted to make and redistribute, without charge, copies of this entire document provided that such copies are complete and unaltered and identify Cooley Godward LLP as the author. All other rights reserved.

Under the new standard, performance-vested options are no longer treated as variable awards, but rather the compensation cost is measured at the grant date, and that cost is recognized based on an estimate of the likelihood of achieving the performance goal, with adjustments made (up or down) each period to reflect the current estimate of forfeitures and the actual number of awards that vest. If the award contains a market condition (e.g., an index-priced option with an exercisability requirement based on achieving a specified measure of the company's stock price), then the recognized compensation cost would not be reversed for awards that have vested.

### **Is it likely that more companies will grant performance-vested options after the effective date of FAS 123(R)?**

Yes. Many companies and institutional investors believe that performance-vested options better align the interests of employees with the company's shareholders. Companies operating under APB 25 have hesitated to use performance-vested options because of the potentially negative impact caused by variable accounting.

### **How will stock appreciation rights (SARs) be accounted for? Will SARs become more popular?**

SARs that may be exercisable into cash (including SARs under which the company or recipient has the ability to elect payout in either cash or stock) will be treated as liability awards, rather than equity awards. Unlike equity awards, under FAS 123(R) the fair value of liability awards will not be measured at the grant date. Rather, the fair value of the award will be measured in a manner similar to a variable award, with the fair value being remeasured at each reporting period. Accordingly, we would not expect to see an increase in the use of SARs exercisable for cash. However, SARs that are exercisable only into stock, or stock options that may be "net exercised" (i.e., options that may be satisfied in stock equal in value to the spread at exercise) will be treated the same as equity awards (i.e., the

same as a regular stock option). These awards have the benefit of ease of exercise and conservation of shares in the plan's share reserve. Moreover, Treasury Department guidance released on December 20, 2004, provides an exception to the new tax rules on deferred compensation for certain stock-settled SARs issued by public companies. Thus, we do expect to see an increase in the use of stock-settled SARs by public issuers. For more information on the new deferred compensation tax rules, please see our [October 14, 2004](#), and [December 22, 2004](#), Alerts on those rules.

### **How will FAS 123(R) apply to IRC §423 employee stock purchase plans (ESPPs)?**

Under APB 25, ESPPs qualifying under Section 423 of the Internal Revenue Code were treated as "non-compensatory" plans, and no compensation cost applied. Previously, under the original FAS 123, if the discount on the date of purchase was not more than 5%, then awards under the ESPP were non-compensatory. Under the exposure draft, however, any discount on purchases of stock under an ESPP likely would have caused the rights granted under the ESPP to be treated as compensatory. FAS 123(R) provides that an ESPP is not compensatory as long as it meets all of the following criteria:

- ▶ The terms of the plan are not more favorable than those available to all holders of that same class of equity, **or** any discount from the market price does not exceed the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering. Note, however, that a purchase discount of 5% or less from the market price shall be considered to comply with this provision without further justification; but a purchase discount greater than 5% that cannot be justified under this condition results in compensation cost for the entire amount of the discount.
- ▶ All full-time employees are eligible to participate in the plan.

- ▶ The plan does not incorporate any look-back feature. That is, the purchase price (and any permitted discount from the purchase price) must be based on the fair market value of the stock on the purchase date, rather than, for example, the initial offering date of the plan.

### **How will stock bonus awards be accounted for?**

Like stock options, the fair value of stock bonus awards will be determined at the grant date and will be recognized over the vesting period of the award. The fair value of a stock bonus award is equal to the fair market value of the underlying stock.

### **How will modifications to awards be accounted for?**

If a company modifies a stock award (e.g., it extends the life of an option or reprices an option), then under FAS 123(R), the transaction will be treated as if the original award was exchanged for a new award. The company would need to recognize as a compensation expense any increase in the fair value of the award on the date of modification over the fair value of the original award immediately before the modification. The additional cost would be recognized on the date of the modification or, for unvested awards, over the remaining vesting period.

Since December 1998, most companies have avoided direct option repricings and opted instead for "6+1" option exchange programs in order to avoid the adverse accounting associated with direct option repricings under APB 25. Stock exchange and stockholder perception issues aside, option repricings may be more palatable from a financial accounting standpoint after the effective date of FAS 123(R).

### **What equity awards might gain popularity under FAS 123(R)?**

The following awards might gain popularity over traditional time-vested stock options:

- ▶ Stock-settled SARs (or "net exercised" stock options)—because fewer shares will be issued and more shares will

remain in the plan's share reserve, available for future issuance.

- ▶ Performance-vested options—because they create a pay-for-performance culture and because FAS 123(R) permits periodic adjustments to reflect the current estimate of forfeitures and the actual number of awards that vest.
- ▶ Index-priced options—because they create a pay-for-performance culture (although forfeitures will not result in a reversal of previously recognized costs).

### What equity awards might become less attractive under FAS 123(R)?

- ▶ Incentive Stock Options—because, unlike the treatment of nonstatutory stock options, the tax benefit (that would be recognized on disqualifying dispositions) may not be recognized in the income statement.
- ▶ Cash SARs—because of the variable cost.
- ▶ Premium-Priced Options—because each \$1 increase in exercise price results in less than \$1 decrease in fair value.

### Impact on Private Companies

#### May private companies continue to operate on a “zero volatility” assumption?

No. Under FAS 123, FASB recognized that it would be nearly impossible for a private company to determine its volatility. Thus, a private company could estimate volatility at zero for purposes of computing the stock option expense. FAS 123(R) eliminates the ability of a private company to assume zero volatility.

Under the exposure draft, the only alternative to accounting for share-based payments with a fair value based on an estimated volatility, was to use an “intrinsic method.” This intrinsic method, however, would result in variable accounting for the entire life of the award. In other words, at each reporting date, the company would “mark-to-market” and record a compensa-

tion cost equal to any increase in the excess of the fair market value of the underlying stock over the exercise price of the option for the life of the award.

Under FAS 123(R), if it is not practicable for a nonpublic entity to estimate the expected volatility of its share price (for example, if it is unable to obtain sufficient historical information about past volatility), then the nonpublic entity may estimate the fair value of its equity awards by substituting the historical volatility of an appropriate industry sector index for the expected volatility of its share price.

### Action Items

- ▶ Review current equity programs and the compensation cost associated with each and consider alternative equity compensation programs.
- ▶ Model the compensation cost associated with alternative equity programs. For example, for Employee Stock Purchase Plans, consider whether the benefits to employees of a compensatory plan outweigh the accounting cost of the plan and whether additional features can be added to the plan to reduce the accounting cost.
- ▶ Create a proper internal control environment to ensure compliance with Section 404 of the Sarbanes-Oxley Act. ■