

Update Regarding Stock Option Accounting: What the Proposed New Rules mean to you and what you can do about it

Introduction

On March 31, 2004, the Financial Accounting Standards Board (FASB) issued its long-awaited exposure draft introducing a proposed standard for “share-based payments.” Share-based payments include stock options, restricted stock, stock appreciation rights, performance shares, employee stock purchase plans, and the like. Note: This Alert does not provide a comprehensive analysis of the proposed standard, and readers should seek advice from their accounting professionals on these issues. While the FASB exposure draft 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 the new exposure draft?

Under the new standard 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 are the new accounting rules effective?

Generally, the proposed standard will be effective with respect to stock options that are granted, modified or settled in fiscal years beginning (1) after December 15, 2004 for public companies (and non-public companies that have voluntarily adopted FAS 123) and (2) after December 15, 2005 for non-public companies.

Will accounting for non-employee grants also be affected?

For the moment, accounting for non-employee awards will not change. The rules of FAS 123 and EITF 96-18 will continue to apply.

Are directors treated as employees or non-employees?

Under the proposed standard, awards to directors (in their capacity as directors) will be treated the same as awards to employees.

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

Yes, under the proposed standard, each public company will be required to recognize a compensation cost with respect to any unvested stock options outstanding on January 1, 2005, equal to the grant date fair value of those options (as previously disclosed in the footnotes to the company's financial statements). As a result, some public companies are considering the acceleration of vesting for underwater options effective December 31, 2004 to avoid the incremental compensation cost associated with those awards under the new standard.

How is an option's fair value determined?

The proposed standard 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.

I have heard about a “lattice” model. What is it, and how does it differ from Black-Scholes?

The binomial model is an example of a lattice model. Such a model uses alternative decision inputs (*i.e.*, it permits companies to use alternative input assumptions over the life of an award). For example, a company could take into account the expected timing of employee exercises of stock options, based on past experience and assuming various future stock prices, in determining the value of the option. FASB believes that a lattice model may result in a better estimate of fair value than a closed-form model (like Black-Scholes). A criticism of FASB's view is that many companies will find it impractical to gather the data necessary to use a lattice model effectively.

Key Attorney Contacts

Dan Meehan	720/566-4061 dmeehan@cooley.com
Buff Miller	650/843-5351 bmiller@cooley.com
Tom Reicher	415/693-2381 treicher@cooley.com
David Walsh	703/456-8021 dwalsh@cooley.com
Thomas Welk	858/550-6016 twelk@cooley.com

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Impact on Traditional Stock Compensation Practices

How does the proposed standard affect 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. For options that vest annually over four years from the grant date, the proposed standard requires companies to account for such options as four separate grants with individual vesting periods. For example, previously under FAS 123, if the fair value of the option on the date of grant was \$24,000 and the option vested $\frac{1}{4}$ each year over four years, then the company would be required to record a compensation cost equal to \$6,000 for each of the four years. Under the proposed standard, the company would be required to treat the option as four separate options and recognize the compensation cost as follows:

Award	Year 1	Year 2	Year 3	Year 4
Vesting Year 1	\$6,000			
Vesting Year 2	\$3,000	\$3,000		
Vesting Year 3	\$2,000	\$2,000	\$2,000	
Vesting Year 4	\$1,500	\$1,500	\$1,500	\$1,500
	\$12,500	\$6,500	\$3,500	\$1,500

This front loads the compensation expense. To complicate matters, under the lattice model, each separate option tranche would have its own set of alternative inputs relating to volatility, dividend rate, risk-free interest rate, employee exercise behavior and post-vesting terminations. The accounting for such awards could quickly become quite cumbersome.

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. 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 the proposed standard?

Yes. Many companies and institutional investors believe that performance-vested options better align the interests of employees with the company's share-

holders. 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 the proposed standard 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) and thus should become more popular because of their ease of exercise and conservation of shares in the plan's share reserve.

How will the proposed standard apply to IRC §423 employee stock purchase plans (ESPPs)?

Under APB 25, ESPPs were treated as "non-compensatory" plans, and no compensation cost applied. Previously, under 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 proposed standard, any discount on purchases of stock under an ESPP likely will cause the rights granted under the ESPP to be treated as compensatory, and accordingly we would expect most of our clients to carefully re-evaluate the use of their ESPPs.

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 the proposed standard, 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 if the proposed standard is adopted.

What equity awards might gain popularity if the proposed standard is implemented?

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 the proposed standard 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).
- ▶ **Discounted options**—because each \$1 in discount results in less than \$1 increase in fair value.

What equity awards might become less attractive if the proposed standard is implemented?

- ▶ **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. The proposed standard eliminates the ability of a private company to assume zero volatility. Rather, if a company is unable to estimate volatility, it may use an “intrinsic method.” This intrinsic method is what we all know under a different name: variable accounting. In other words, 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) for the life of the award. Once the proposed standard becomes effective, we expect that non-public companies contemplating an initial public offering will choose to estimate the volatility of their untraded stock.

Action Items

Is there a comment period?

Yes. The comment deadline is June 30, 2004, and we recommend that our clients and friends respond to FASB within the 90-day comment period with concerns.

What is the status of the proposed legislation to address the proposed standard?

The companion Enzi/Reid (S. 1890) and Baker/Eshoo (H.R. 3574) Stock Option Accounting Reform Act of 2003 currently has over 100 co-sponsors and appears to be gaining support in both the Senate and the House. It is unclear, however, whether the support will be strong enough to carry the bill through.

Are there organizations that are actively lobbying Congress?

Yes, TechNet (www.technet.org), the American Electronics Association (www.aeanet.org) and the International Employee Stock Options Coalition (www.savestockoptions.org) are examples of such organizations. n