



FAS 123R – What Does It Really Mean?

*By
Thomas B. Wilson
President*

The Security and Exchange Commission (SEC) has changed its regulations for how companies financially account for their stock options. Prior to this change, a company could offer stock options to employees, and if there was a gain realized between the grant price and the sold price, there was no charge to the company's profit and loss statement. That has all changed and it has caused some very serious and important reexamination on the value of these programs.

This new regulation of the Federal Accounting Standards Board (FASB) changes how companies treat equity-related compensation. This regulation, referred to as "Shared-Based Payment" or FAS 123R ("R" means that it was revised from an earlier version), will require companies to charge the calculated cost of stock options and employee stock purchase plans (that don't comply with certain provisions) as a compensation expense on financial statements reported to the SEC and shareholders.

This paper seeks to summarize and clarify these new regulations and discuss their implications. We will not discuss the reasons or the pro's and con's of this regulation, but rather focus on what companies should consider in determining what to do. Some companies will use this as an opportunity to make much needed changes and others will seek creative ways to minimize the costs of retaining the current programs. Hopefully, this paper will provide you with both a basic background and some strategies or at least some ideas on how your organization should utilize equity compensation to its fullest value. Regardless of your approach, this is an important time to examine what you do and why you do it.

Highlights of the Key Requirements of FAS 123R

The following is a list of the primary requirements of this legislation. If you wish a more detailed description of the regulations, please contact your accounting or legal advisors, contact us, or see the references at the end of this paper.

1. **The requirement for the compliance** of public companies is effective at the start of the company's fiscal year beginning after June 15th, 2005. For private and smaller companies that are required to submit reports to the SEC, the compliance will begin with their fiscal year after December 15, 2005.
2. **The amount of the expense for stock options is based on the "fair value"**. The fair value can be calculated by a number of methods, such as Black-Scholes-Merton or the Lattice Binominal methods. The company may select the valuation methodology it prefers as long as it meets FASB's requirements.
3. **The valuation methodology is set at the grant date for the stock options.** It will not be easy for companies to change the valuation method once the program has been approved (any change will need to comply with the appropriate accounting estimate regulations under APB 20 – Accounting Changes). The method may change for future programs if the structure of the program is significantly different or the conditions of the company have dramatically changed.
4. **The costs associated with this fair value are recognized (or charged) as a compensation expense on the company's profit and loss statement over the vesting period of the awards (also known as the "requisite service period")**. If the vesting period is four (4) years, then the costs of the options can be spread out by 25% per year. The company may use a straight-line or accelerated expense amortization method even though the options have a graded, non-linear vesting requirement. For example, if a company has a 4 year vesting schedule that is 40%, 20%, 20% and 20% for each year respectively, it can expense the option costs at 25% per year (straight line method) or it can front-end load the expenses.
5. **If a company uses vesting requirements** based on time (i.e., employed by the company) or performance (i.e., based on internal factors like revenue growth, EBITDA, or strategic goals), **it may adjust the recognized expense if the actual cost is different than what was initially recorded**. This is often referred to as "true-up" the recorded stock option expense. If the vesting requirements are based on external or "market-factors" (e.g., stock price, shareholder return, etc.), then the company may not "true-up" the actual costs versus initial expense recognition. Further, the recognized option expense may not be adjusted if an option is forfeited or expires without being exercised.
6. **From an accounting perspective**, if the actual expense for an option award is more than the recognized expense, the additional deduction would be recognized as paid-in-capital on the balance sheet. If the actual expense is less than the initial option expense, the adjustment would be recognized as paid-in-capital and would offset earlier adjustments. On cash flow statements, the excess deduction would be recorded as financing cash inflow.

7. **If the provisions for Employee Stock Purchase Plans (ESPPs)** do not meet the following three conditions, the costs to acquire shares (above the employee's contributions) will need to be expensed:
 - a. The purchase price is not discounted more than 5% of the fair market value on the purchase date,
 - b. There is no look-back provisions in the plan, *and*
 - c. The plan is broad-based within the organization.

Since most plans today enable employees to receive a discount greater than 5% (the current practice is more like 15%) and the shares are acquired based on the lowest price over the past two years (i.e., look-back), there will be additional costs for these programs if they are not changed.

8. **These regulations apply to incentive plans where the awards are made in equity** (e.g., stock options, restricted shares, performance shares, stock appreciation rights settled in shares). Incentive plans that are settled in cash (e.g., stock appreciation rights in cash or long-term cash/unit plans) will be measured and accrued as an expense on a quarterly basis.

Determining the Costs of Your Options

The primary implication of these new regulations is that the costs associated with equity based plans will increase. This cost may be extensive for companies that have used these plans widely. This additional cost could impact the market attractiveness of the share price and the reported financial condition of the company. However, these programs have significant value for some companies, and their benefits need to be considered in light of their potential costs. This is something Board, executives, shareholders, prospective investors and investment advisors will need to reconcile.

For many companies, equity-based compensation has been an important element of their total compensation portfolio. For early-stage companies, it has been an important tool to attract and retain talent when highly competitive cash compensation was not possible. For large employee-oriented companies, it has been an important "share in the success of the enterprise" benefit, consistent with a progressive leadership philosophy. But, now these programs are potentially going to cost the company significant dollars, at least from a pre-tax, accrual accounting perspective.

The costs for stock options are determined by calculating the fair value of all current unvested stock options. The fair value can be determined using the Black-Scholes-Merton method of valuation or newer, more flexible methods such as the Lattice-Binomial methods. The purpose of these mathematical models is to establish a projected gain of a stock option based on a number of historical and current option plan factors.

These models incorporate several important factors to determine the fair value, such as:

1. The exercise price for the option,
2. The current market price of the shares at the grant date (if different than the exercise price),
3. Expected term (or when people will likely exercise the option),
4. Volatility of a stock price,
5. Expected dividends, *and*
6. Risk-free rate of return on investments (such as Treasury Bills).

The primary differences between the Black-Scholes and the Binominal methods are in their current usage and their flexibility to reflect a particular company's situation. Black-Scholes has existed for many years and has been used by most companies when reporting the earnings per share impact of their equity compensation (shown as footnotes in previous SEC proxy filings). The Black-Scholes method uses the value of these elements consistently over the actual term of the option. For example, it assumes the historical stock price volatility will remain the same and that all people will exercise their options on the last day of the option's term (usually 10 years).

In contrast, Binominal methods (including Hull-White Binomial Model, Cox-Ross-Rubinstein Binomial Model, etc.) permit the company to establish these factors for each year of the option term. It enables a company to vary the projected stock volatility, expected term (or when people will likely exercise their option), and forfeitures rates (which are not included in Black-Scholes). This enables the firm to use more precise projections for those factors that it can influence. For many companies, particularly in dynamic technology and life sciences industries, this is likely to result in a lower fair value than with the Black-Scholes method.

Consequently, the method the company uses to determine the value of the stock option is a very important determinant of its costs. Once the valuation methodology has been selected and the company has established key assumptions of the model, it can determine the fair value or costs of the options. Then, the costs are amortized over the vesting period of the options (either by an accelerated or straight-line method). The cost will be included as a compensation expense on the company's profit and loss statement and will be reflected in the earnings per share reported to shareholders.

Consider the example below of a company that has made extensive use of stock options in the past, and makes certain adjustments going forward. In this example, note the impact of the fair value costs when the company makes these changes:

- a. It reduces the number of options awarded from 6 million in 2005 to 4 million in 2006.
- b. It increases the number of options awarded in 2007 to 6 million to take advantage of lower exercise price.
- c. It reduces the number of options awarded again in 2008 to 3 million.

ABC Technology Corporation: Projected Expenses for Stock Options:				
	<small>(note: M = million)</small>			
	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
Stock price:	\$10.00	\$12.00	\$8.00	\$14.00
No. unvested options:	20M	21M	19.8M	20.9M
No. options vested: (4 year cycle)	5M	5.3M	5M	5.2M
No. new options granted:	6M	4M	6M	3M
Total number of <u>unvested</u> options:	21M	19.8M	20.9M	18.7M
Avg. "Fair Value" per stock option:	\$4.11	\$4.62	\$4.37	\$4.24
Total <u>value of unvested</u> stock options (\$ to be expensed):	\$21.7M	\$22.9M	\$22.8M	\$19.9M
Projected impact on earnings per share (200M shares outstanding)	\$ (0.11)	\$ (0.11)	\$ (0.11)	\$ (0.10)

In this example, the company is likely to face \$22 million in additional compensation expenses. This translates into a reduction of reported earning by approximately 11¢ per share. Once the cost is known and projected for subsequent years, the question is: **Is this cost acceptable?** If the cost is acceptable and there is likely to be little impact on the share price or financial health of the company, then the task is to comply with the requirements. If the cost is not acceptable, or the company seeks to reduce the costs as much as possible, then it needs to determine which action will provide the greatest return on investment.

The above illustration shows the impact of several actions. Reducing the number of options awarded does not have an immediate effect on the cost impact because of the existing "inventory" of options. Granting more options when the price is low has minimal immediate impact on the costs. While the accelerating the vesting schedule may reduce the existing inventory (as people exercise options more quickly), it also increases the costs because the value of the options are recognized in relation to the vesting schedule. Therefore, the Board of Directors and executive management should develop solutions that have lasting desired impact.

Assessing Your Situation

This overview of the requirements should encourage you to examine your company's use of equity based compensation. This is perhaps the most critical and opportune time to consider reviewing one's total reward portfolio, and assuring they produce the value intended. Many companies are examining what they are doing, and are implementing change. In fact, in a recent survey on the changes in equity compensation ("Survey on Changes In Equity Compensation – 2006-2007" by the Wilson Group:

www.wilsongroup.com), we found:

- ⊕ 52% of the participating companies implemented changes in their equity compensation plans in 2006.
- ⊕ 56% are planning or considering changes in their plans in 2007.

Before taking action, we recommend that you pursue the following steps:

1. Determine the **potential costs** of the existing equity programs. Then determine if the **costs are worth the value received** from them. Consider:
 - a. The financial impact on your profit & loss statement, earnings per share.
 - b. A comparison of these costs to your peer companies – it may be that their costs are greater or not as great. Investors often examine a firm's financial performance in relation to its industry peer group.
 - c. The reasons for the costs and the likelihood that the causes are temporary (based on a previous major award) or permanent.
2. **Identify the leadership philosophy, performance goals and key objectives for your equity compensation program.** Note the objectives may differ by organizational level, type of job responsibility and demographics (i.e., personal values) of your people. Ask why are these programs important to your organization, your philosophy and culture?
3. **Assess how well the current equity programs encourage and reinforce this philosophy and achieve their objectives.** Examine how effective and important these programs are to your ability to attract and retain critical talent; examine how well they encourage "enterprise value" thinking, decision making and commitment. What could be the value of alternative equity and cash based incentive compensation plans. Then, **determine what needs to be either changed or developed** to enhance the desired impact on the organization.
4. **Establish the priorities for what needs to change and then take action.** Many reward programs that exist today were developed for under a different set of market forces, regulatory requirements and organizational realities. This

means that the new programs need to be future focused and support where the organization is heading. Once the decisions have been made on what needs to change based on these tasks, rapid and effective implementation is critical.

5. **Communicate the changes to those most affected.** There is no action more important than communicating clearly and directly about why the changes are being made and what impact they may have on the individual's relationship with the company. It is not just important for people to understand what is going to change, but why and what it means for them. This often requires discussion, face-to-face meetings and the value of these meetings can far exceed the potential loss one may experience. By limiting this communication, you will likely significantly increase your risk of losing great talent or decreasing the performance commitment of your most important individuals. We have found that people will "fill in the void" that the company does not provide, and the reasons people create in their own minds are often far worse than the truth.

We hope this paper has provided both useful information and guidance on moving forward. We believe, and have developed and witnessed with many of our clients, the importance of an "ownership" mentality within the organization. Equity compensation programs are often a critical tool for encouraging and reinforcing this mentality. When equity programs are combined with other performance based reward programs and effective leadership practices, people care more for their company, its competitiveness and their own performance. Equity programs now come with a cost. The challenge to an organization's leaders and those who support and advise them is to devise a program that provides a strong return on investment, from financial, talent management and performance perspectives.

If we can be of assistance to you in the assessment, development and implementation of the changes you seek, it would be our pleasure to work with you. All you need to do is give us a call. You may contact us at: 978-371-0476 or TWilson@wilsongroup.com.

Thank you

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