



# Financial Reporting

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## Employers Brace for Expected Changes in Accounting for Stock Options

*This Financial Reporting letter was prepared and distributed by BDO Seidman, LLP to help our clients come to grips with the likely impact of the FASB's proposal on Share-Based Payment.*

The FASB's proposal, *Share-Based Payment*, arrived on March 31st determined to write a new ending to a standard that some consider as unfinished as that symphony from Schubert. Far from bringing peace and harmony, this newborn arrived amidst a chorus of prepared statements and press releases.

This is not the first time that participants in the financial reporting process have turned to Congress and the media on the subject of accounting for stock options. Nor is it the first time that technical issues have become mired in emotion as supporters and opponents have faltered in their attempts to turn the pros and cons of changes in accounting standards into "plain English" concepts that can be understood on Main Street as well as Wall Street.

Ten years ago, the issues were driven by perceptions of stock option plans as "stealth compensation" that secretly transferred wealth from shareholders to employees. Today, the issues appear to be driven more by perceived excesses in executive compensation and demands for reforms in corporate governance. Many public companies have already adapted their executive compensation models to these realities. Yet the combination of these and other factors has created a kind of "perfect storm" for the FASB to move forward with its proposal.

At BDO Seidman, we believe the proposal should be decided on the merits of sound accounting policy.

We also believe that the final standard is not likely to change much from the proposal. Companies should take the necessary steps now, so they can be pre-

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pared to make the right choices under the final standard and explain any changes in their compensation strategies to investors. Toward that end, we have prepared this *Financial Reporting* letter to advise our clients and friends of the key accounting issues and their possible implications. We have aimed at capturing the major issues and conclusions, rather than every detail, in the lengthy Exposure Draft, or ED.

The ED can perhaps best be analyzed and compared to existing accounting standards through a series of issues:

- What is the scope of the ED? What plans does it cover?
- Is the plan compensatory for financial accounting purposes?
- Does the plan create equity interests or liabilities?
- If the plan is compensatory, when is compensation measured?
- If the plan is compensatory, how is compensation measured?
- If the plan is compensatory, over what period is compensation recorded?
- How are modifications of grants treated?
- How are income tax consequences accounted for?
- What disclosures should be presented?

### **1** What is the scope of the ED? What plans does it cover?

The ED covers plans for employees that convey shares of the employer's stock, derivatives (such as options) related to the employer's shares, or cash in amounts tied to the value of the employer's shares. Employee is defined the same as in FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation: an interpretation of APB Opinion*

No. 25, as a person over whom the grantor exercises or has the right to exercise sufficient control to establish an employer-employee relationship. A grantee meets the definition of an employee if the grantor consistently represents that individual to be an employee under common law. In the U.S., this means that the grantee must be an employee for U.S. payroll tax purposes and an employee of the grantor under common law. In addition, certain leased employees qualify as employees, consistent with Interpretation 44. Finally, also consistent with Interpretation 44, awards to nonemployee members of the board of directors in their capacity as directors are covered in the scope.

Other than the specific exceptions for leased employees and nonemployee directors, the ED does not cover plans for nonemployees. The FASB potentially will deal with nonemployees, as well as Employee Stock Ownership Plans (ESOPs), in a subsequent phase of the project. Therefore, the accounting for grants to independent contractors, including consultants and other nonemployee service providers, as well as to employees of joint ventures and equity method investees, will continue to be governed by the consensus in Emerging Issues Task Force (EITF) Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services." That consensus differs in some respects from the accounting required in the ED, most notably the date on which compensation is measured and the assumed term used in an option pricing model. This will continue to be burdensome for employers whose employees frequently change status for accounting purposes, for

example, employers who regularly transfer employees to and from corporate joint ventures.

### **2** Is the plan compensatory for financial accounting purposes?

All plans are considered compensatory unless the benefit to employees is no greater than the benefit available to shareholders generally. The benefit to employees is assessed based both on the discount from market price and the number of shares they are eligible to buy. As a result, virtually all plans will be considered compensatory for accounting purposes, including employee stock purchase plans that are noncompensatory for U.S. Federal income tax purposes under Section 423 of the Internal Revenue Code. For example, if the employee plan provides a discount from quoted market price that is not available to shareholders generally, the plan would be compensatory. If the employee plan provides a discount that is equivalent to the discount available to shareholders generally, for example, through a dividend reinvestment plan, but employees are eligible to buy more shares than a typical shareholder, the plan would be compensatory. The FASB adopted this approach as part of its effort to make standards more consistent with underlying principles by minimizing exceptions.

*How the ED differs from APB Opinion No. 25.* The criteria for noncompensatory plans under Opinion 25 came from Section 423. As a result, plans that are noncompensatory for U.S. Federal income tax purposes generally qualify as noncompensatory under Opinion 25. As the income tax rules were interpreted over the years, some noncompensatory plans became quite

lucrative for employees. For example, “lookback” plans under which employees pay 85% of the lesser of market price at the beginning or end of a 12-month period result in substantial gains to employees in periods of rising share prices.

*How the ED differs from FASB Statement No. 123.* As compared to Opinion 25, Statement 123 introduced stricter criteria for designating a plan as noncompensatory for accounting purposes. Most noncompensatory plans under Section 423 are compensatory plans under the criteria of Statement 123. However, under Statement 123, plans with a discount of five percent or less from quoted market price may be noncompensatory if they are offered on an equitable basis to all employees and have no significant option features. Under the ED, these plans will be compensatory unless similar purchase privileges are available to shareholders generally.

### **3 Does the plan create equity interests or liabilities?**

Under the ED, an employer would assess the employees’ rights under the plan in accordance with FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, to determine whether those rights constitute equity interests or liabilities. After making that assessment, the ED governs recognition and measurement of compensation expense, and liabilities are accounted for differently from equity interests. Generally, plans that are settled by

issuing shares to employees, including “cashless exercise” (net share settled) options, would create equity interests, and plans that are settled by issuing cash to employees would create liabilities. However, Statement 150 is complex, and employers will need to analyze their plans to determine whether they contain features that would cause the awards issued to create liabilities under Statement 150<sup>1</sup>.

*How the ED differs from Opinion 25.* Opinion 25 does not distinguish between equity and liability awards.

*How the ED differs from Statement 123.* Statement 123 makes a similar distinction between equity and liability awards. Most, but not all, awards are classified the same under the ED as under Statement 123.

### **4 If the plan is compensatory, when is compensation measured?**

*For equity interests.* Compensation for equity interests is measured at date of grant and generally is not adjusted subsequently unless the employee forfeits the award by failing to complete the required period of employee service. Private<sup>2</sup> companies are permitted to measure compensation for options at exercise date instead of grant date. This alternative is discussed in more detail in the next section on how to measure compensation.

*For liabilities.* Compensation for liabilities is measured at the exercise or settlement date, but compensation is estimated at each reporting date from grant date to exercise or

settlement date, much like variable accounting under Opinion 25.

*How the ED differs from Opinion 25.* Under Opinion 25, compensation for some plans is measured at grant date and compensation for other plans is measured at a later date, typically either vesting date or exercise or settlement date, with compensation estimated at each reporting date. However, the dividing line in Opinion 25 relates to when the amount the employee must pay and the number of shares the employee is entitled to are known. If both factors are known at grant date, and vesting is not dependent on anything other than continued employment, compensation is measured at the grant date. Absent these conditions, compensation is measured at a later date when these factors become known, with interim estimates beginning at grant date. If the number of shares is not known solely because of uncertainty about whether the employee will render service for a stated period, the factors are known at grant date. If any other uncertainty exists about the number of shares, final measurement of compensation is delayed until that uncertainty is resolved. Situations involving delayed measurement often are referred to as variable accounting, because the amount of compensation expense varies from period to period as the price of the company’s shares changes.

*How the ED differs from Statement 123.* Statement 123 is similar to the ED, in that compensation for equity interests is measured at grant date

<sup>1</sup>For a more complete description of the requirements of Statement 150, see our *Financial Reporting Letter, FASB Statement No. 150 Brings Big Changes* (July 2003), at [http://www.bdo.com/about/publications/assurance/fr\\_july\\_03/](http://www.bdo.com/about/publications/assurance/fr_july_03/).

<sup>2</sup>Private is defined in the same way as in Statement 123 as a company that does not have publicly traded shares and is not preparing to list its shares. Thus, a company that is an SEC registrant solely because it has publicly traded debt would be considered private under the ED.

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and compensation for liabilities is measured at exercise or settlement date with interim estimates.

### **5** If the plan is compensatory, how is compensation measured?

Compensation is measured based on the fair value of the instruments issued to employees. For shares, fair value is the quoted market price of the shares if they are traded. For options, fair value is estimated using a recognized option-pricing model that incorporates all of the following assumptions:

- Current fair value of underlying shares
- Option exercise price
- Expected term of option
- Expected dividend yield over the expected term of the option
- Risk-free interest rate over the expected term of the option
- Expected volatility of the stock price over the expected term of the option

The Black-Scholes and binomial (Cox-Ross-Rubinstein) models are examples of option-pricing models that would qualify. The FASB expresses a preference for “lattice” models like binomial over “closed form” models like Black-Scholes. Lattice models allow assumptions like expected dividend yield and expected volatility to vary over time, whereas closed form models hold the assumptions fixed over the term of the option. Lattice models also allow the employer to make explicit assumptions about the employees’ likely exercise patterns. For example, an employer could assume, based on past experience, that employees will exercise half their options when the market price of the shares reaches 200% of the exercise price. The FASB’s preference for lattice models is based on

a belief that the flexibility in the assumptions leads to more precise estimates of fair value. However, applying a lattice model requires detailed information about past employee behavior. Many employers have never accumulated such information and, therefore, would be unable to apply a lattice model, at least initially. Small employers, even if they have the information, may not feel that the employee base is sufficiently large for the data to be statistically significant. The ED is unclear about whether an employer who has the necessary information is required to apply a lattice model, or whether Black-Scholes is permitted as a less preferable alternative.

Like Statement 123, the ED is based on a modified grant date model in which zero compensation is recorded for options or shares that an employee forfeits through failure to meet service (employment) or performance (either individual or company performance targets) conditions. Accordingly, restrictions on shares or options during the period before vesting are ignored in estimating fair value, because it would be double counting to reduce the fair value for such restrictions and also to reverse compensation for forfeited awards. Restrictions after vesting, for example, a requirement for an employee to hold the shares for a specified period, would be considered in estimating fair value. Also like Statement 123, the effect of a market condition on vesting (for example, an option that becomes exercisable only if the stock price exceeds a certain amount) is factored into the fair value estimate, and compensation is not reversed if the award never vests because the target condition isn’t reached.

*Alternative method for private companies.* As mentioned in the preceding section, an alternative approach is available for a private company that does not want to incur the cost of valuing stock options using an option-pricing model. A private company may choose to measure compensation for employee stock options based on their intrinsic value at their exercise or settlement date, with interim estimates of compensation based on intrinsic value at each reporting date between grant date and exercise or settlement date (that is, variable accounting would apply). This would be an accounting policy choice that would apply to all employee stock options.

*How the ED differs from Opinion 25.* Under Opinion 25, compensation is measured based on intrinsic value, that is, the difference between the amount the employee must pay and the fair value of the shares on the date compensation is measured. For share grants, intrinsic value typically equals fair value, because the amount the employee must pay usually is zero. For options, however, fair value and intrinsic value differ significantly at grant date. If the exercise price equals or exceeds the fair value of the shares at grant date, the intrinsic value is zero, but the option has fair value equal to its time value. Time value can be understood economically as the employee’s benefit from the right to profit from appreciation of the shares without the burden of buying the shares and having an investment at risk. For those private companies that opt to use the intrinsic value method to account for their employee stock options, the ED differs from Opinion 25 in that, even if the options meet the requirements to measure compensation at grant

date under Opinion 25, the ED requires variable accounting for such options through the exercise or settlement date.

*How the ED differs from Statement 123.* Whereas Statement 123 permits an employer to choose between the intrinsic value model of Opinion 25 and the fair value model of Statement 123, the ED would require use of the fair value model (other than the limited private company exception described above). The ED also refines the fair value model as compared to Statement 123.

- Statement 123 refers to the binomial model as an acceptable approach, but expresses no preference between the binomial and Black-Scholes models. As noted above, the ED expresses a preference for lattice models, of which the binomial model is the best known.
- The ED provides more guidance on how to develop the assumptions needed to apply the binomial model.
- The ED provides more guidance on the most difficult assumption in option-pricing models—the expected volatility of the stock price. Statement 123 notes that estimating the expected volatility of the stock price would likely begin with the historical volatility and discusses in general terms how historical volatility

might be adjusted to estimate expected volatility. The ED provides more discussion and guidance on how to develop estimates of expected volatility and explicitly states that unadjusted historical volatility is not an appropriate substitute for expected volatility.

- Liability awards are measured at intrinsic value under Statement 123. Under the ED, they are measured at fair value. Cumulatively the same compensation expense is recorded, because at exercise or settlement date fair value and intrinsic value are the same. However, for option-like liability awards, the interim estimates of compensation will differ.
- Finally, the exception method for private companies is different. Under Statement 123, the alternative to fair value for private companies is to measure options using “minimum value” at grant date. Minimum value is computed by applying the Black-Scholes model with an expected stock price volatility of zero.

**6** If the plan is compensatory, over what period is compensation recorded?

Compensation is accrued ratably over the vesting period. Ultimately, compensation is recorded only for awards that vest, that is, awards for

which the employees fulfill any service requirements and meet any performance conditions. If an employee forfeits an award because he fails to fulfill a service requirement or fails to achieve a performance condition, no compensation cost is recorded for the forfeited award. If compensation was accrued in earlier periods, it is reversed in the period of forfeiture. If an employee fulfills all of the conditions and vests in an award but does not exercise it, because the stock price falls and makes exercise uneconomic, compensation cost is not reversed. Also, as noted previously, if an employee forfeits an award because a market condition is not satisfied, compensation is not reversed.

If an award has graded vesting, for example, 25 percent per year for four years, each tranche of the award is accounted for as if it were a separate award, with compensation accrued over its individual service period. This results in faster recognition of compensation expense than straight-line accrual over the total life of the combined award. For example, if an employer grants 100 shares of restricted stock with a fair value of \$10 per share at grant date, with 25% vesting on each of the first four anniversary dates, compensation for each tranche of 25 shares would be accrued as follows:

**Illustration of Compensation Expense by Year for Award with Graded Vesting**

Anniversary	Shares Vesting	Compensation Expense	Year			
			Year 1	Year 2	Year 3	Year 4
First	25	\$250	\$250	\$0	\$0	\$0
Second	25	250	125	125	0	0
Third	25	250	83	83	84	0
Fourth	25	250	62	63	62	63
Total expense by year			\$520	\$271	\$146	\$63

Note that more than 50% of the aggregate \$1,000 of compensation expense is accrued over the first 12 months.

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Employers are required to estimate the percentage of awards that will vest and accrue compensation for that number of awards. The estimate is updated regularly based on actual experience, and compensation is adjusted via a cumulative catch-up to reflect the latest estimate. Ultimately, compensation is trued up to reflect actual forfeitures.

*How the ED differs from Opinion 25.* Opinion 25 has similar concepts that compensation is accrued over the service period and that zero compensation is recorded for forfeited awards. However, Opinion 25 has no specific requirement to estimate vesting or for how or when to reflect forfeitures. For awards with graded vesting, Opinion 25 requires separate accounting by tranche only for variable awards (those for which either the price the employee must pay or the number of shares is not known at date of grant). For fixed awards (those for which both the price the employee must pay and the number of shares are known at date of grant), practice predominantly treats the entire award as a unit and amortizes compensation expense over the period to the last vesting date.

*How the ED differs from Statement 123.* Statement 123 has similar concepts that compensation is accrued over the service period and that zero compensation is recorded for forfeited awards. However, Statement 123 permits employers to accrue compensation for 100% of awards and record reversals of compensation as employees forfeit or to estimate the number of awards that will vest. The ED eliminates that choice. For awards with graded vesting, Statement 123 permits employers a choice between accounting for the

entire award as a unit or accounting for the individual tranches. The ED also eliminates that choice.

### **7** How are modifications of grants treated?

A modification is defined broadly as any change to an award's terms, including exercise price, number of shares, life, vesting conditions, settlement provisions, etc. Modifications encompass changes in conjunction with an equity restructuring, such as a spin-off, stock split or dividend, rights offering, or large nonrecurring cash dividend. A modification is viewed as the cancellation of the original award in exchange for the modified award. As a result, for equity awards, compensation cannot be less than the original grant date estimate of compensation, unless the original award was likely to be forfeited. If the fair value of the modified award exceeds the fair value of the original award as of the modification date, the incremental fair value, plus any remaining unamortized compensation from the grant date valuation of the original award, are combined and amortized over the vesting period of the modified award.

*How the ED differs from Opinion 25.* Because the Opinion 25 model is so different from the fair value model, modifications are treated very differently under Opinion 25, and it is difficult to make a meaningful comparison. In 2000 and 2001, the FASB and the EITF provided extensive guidance on accounting for modifications under Opinion 25.

*How the ED differs from Statement 123.* Accounting for modifications under Statement 123 is similar in concept to the accounting under the ED. As

a result of the extensive recent work on accounting for different kinds of modifications under Opinion 25, the ED has more examples of modifications and more implementation guidance than Statement 123.

### **8** How are income tax consequences accounted for?

The key principle in the ED is that ultimately the income tax benefit recorded in earnings is equal to the lesser of (1) the tax benefit realized on the tax return or (2) the cumulative compensation expense for financial reporting purposes multiplied by the statutory income tax rate.

In the U.S., for most employee awards covered by the ED, the employer receives a tax deduction for compensation at date of exercise or settlement equal to the intrinsic value of the award at that date. For awards classified as liabilities under the ED, the tax deduction will equal the cumulative compensation expense for financial reporting purposes, although the timing will differ. Therefore, the employer treats the accrued liability as a temporary difference and records a deferred tax asset and a deferred tax benefit as it accrues compensation for financial reporting. The deferred tax asset is assessed for realizability like other deferred tax assets under FASB Statement No. 109, *Accounting for Income Taxes*.

For awards classified as equity interests under the ED, both the amount of the tax deduction and its timing will differ from the financial reporting compensation expense. The ED defines the cumulative compensation expense for financial reporting purposes as a temporary difference. Accordingly, the employer records a deferred tax asset and a deferred tax benefit as it accrues

compensation for financial reporting. The deferred tax asset is assessed for realizability like other deferred tax assets under Statement 109. In assessing realizability, the employer should consider the likelihood of future taxable income but should not consider the current stock price. Then, upon exercise or settlement, the employer compares the tax deduction claimed on the tax return to the cumulative compensation expense for financial reporting purposes. If the tax deduction is bigger, the realized tax benefit in excess of the deferred tax asset is recorded as additional paid in capital. If the tax deduction is smaller, the unrealized part of the deferred tax asset is charged to income tax expense.

If the award is of a type that ordinarily would not generate an income tax benefit, such as an incentive stock option (ISO) as defined in Section 422 of the Internal Revenue Code, the compensation accrued for financial reporting purposes is not a temporary difference, and the employer records no deferred tax asset as it accrues compensation for financial reporting. If the employee makes a disqualifying disposition and the employer receives a tax deduction, the amount of benefit reported in earnings is limited to the lesser of (1) the actual tax benefit received or (2) the cumulative compensation expense for financial reporting purposes multiplied by the statutory income tax rate.

*How the ED differs from Opinion 25.* Because most stock options have zero compensation expense under Opinion 25, there is no need to record deferred tax assets, and there is no possibility that the tax deduction could be smaller than the

cumulative compensation expense for financial reporting purposes. The tax benefit for the compensation deduction claimed on the tax return is recorded as additional paid-in capital, similar to the ED. For the minority of plans that create compensation expense for financial reporting purposes that is measured differently from the tax deduction (for example, a stock option granted with an exercise price below market price on date of grant), the benefit of a tax deduction in excess of cumulative compensation for financial reporting is credited to additional paid-in capital. If the tax deduction is less than cumulative compensation for financial reporting, the shortfall is charged to additional paid-in capital to the extent of prior credits to capital. Any shortfall in excess of prior credits to capital is charged to income tax expense.

*How the ED differs from Statement 123.* If the compensation deduction on the tax return is less than cumulative compensation expense for financial reporting, the effect of the shortfall is charged to additional paid-in capital to the extent of prior credits to capital recorded under Statement 123. In other respects the accounting for income taxes in the ED is the same as Statement 123.

## 9 What disclosures should be presented?

The ED sets forth four objectives of disclosure, and then specifies the minimum disclosures necessary to achieve those objectives. The objectives are to enable the readers of the financial statements to understand (1) the nature and general terms of the arrangements in existence and the potential effects on the shareholders, (2) the compen-

sation expense reported in income, (3) the methods used to estimate fair value, and (4) the cash flow effects. The minimum disclosures are as follows. New disclosures are highlighted with boldface type.

- A description of the arrangements in existence—general terms, required employee service periods and other vesting conditions, maximum contractual term, and number of authorized shares.
- For the most recent year, a roll-forward of the share and option awards outstanding from the beginning of the year to the end of the year showing the activity (new grants, exercises, forfeitures, and expirations), with supplemental disclosure of how many options outstanding at the end of the year are currently exercisable. The rollforward should present weighted-average exercise prices for options and weighted-average grant-date fair values for shares.
- For each year for which an income statement is presented, the weighted-average grant date fair values of awards granted (intrinsic value for private companies electing that alternative) and **the total intrinsic value of options exercised or shares vested.**
- **For stock options that are vested at the latest balance sheet date or expected to vest, the number, weighted-average exercise price, aggregate intrinsic value, and weighted-average remaining contractual term, with separate disclosure of total options and vested options.**
- The preceding disclosures should be presented separately for different types of awards, for example, options with fixed versus

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indexed exercise prices, options with only service conditions versus options with performance conditions, or awards classified as liabilities versus equity.

- For each year for which an income statement is presented, **a description of the method used to estimate fair value**<sup>3</sup>, a description of the significant assumptions used (expected term, expected volatility, expected dividends, risk-free rates, and discounts for post-vesting restrictions), total compensation cost included in income, **total related income tax effect included in income, total compensation cost capitalized in the cost of assets**, and a description of significant modifications.
- **As of the latest balance sheet date, total compensation cost to be recorded in future years related to nonvested awards and the weighted-average period over which it will be recorded.**
- **The amount of cash received from exercise of share options, the excess tax benefit recorded in shareholders' equity, and the amount of cash used to settle equity grants.** The ED does not specify a period for these disclosures. We believe the FASB intends for them to be presented for each period for which a cash flow statement is presented.
- **The entity's policy for obtaining shares to be issued upon exercise of options and, if the policy is to purchase treasury shares for this purpose, the estimated number of shares to be repurchased in the next year.**

*How the ED differs from Statement 123*<sup>4</sup>.

The FASB has both added and deleted disclosures and has modified some of the continuing disclosures. The major deletions include:

- Going forward, there is no need for pro forma disclosure of earnings and earnings per share under the fair value method, because substantially all employers will be applying the fair value method in their income statements. The pro forma disclosures for prior years presented for comparative purposes will continue to be required (except for private companies electing the intrinsic value alternative).
- The rollforwards (disclosure 2 above) are required only for the most recent year instead of all years for which an income statement is presented. In addition, it is no longer necessary to disclose the range of exercise prices for options outstanding at the latest balance sheet date.
- The weighted-average grant-date fair values (disclosure 3 above) no longer need to be disclosed separately for options that are in the money, at the money, or out of the money at grant date<sup>5</sup>.

### Effective Date and Transition

The ED proposes different effective dates and transition methods for private and public companies. This summary identifies the general provisions that are relevant for most companies. A private company that already applies the fair value method under Statement 123 or a company that has grants that

change from equity under Statement 123 to liability under the ED, or vice versa, faces additional issues.

*Private companies.* The ED proposes that private companies adopt the new accounting prospectively for new or modified grants for fiscal years beginning after December 15, 2005. Prospective adoption means that awards granted in earlier fiscal years continue to be accounted for using the existing accounting, typically Opinion 25.

*Public companies.* The ED proposes that public companies adopt the new accounting under the modified prospective method in fiscal years beginning after December 15, 2004. Modified prospective means that for fiscal years beginning after December 15, 2004, (1) new grants and modified grants are accounted for in accordance with the ED and (2) awards granted in earlier fiscal years that are not yet vested are accounted for in accordance with the fair value model of Statement 123. For companies that currently apply Opinion 25, this transition method effectively brings into the income statement for fiscal years after the effective date the compensation expense that previously would have been reported in the pro forma disclosures.

If a company voluntarily adopted the fair value method in accordance with Statement 123 and FASB Statement No. 148, it had three choices on transition—prospective, modified prospective, and retrospective. If the company chose retrospective or modified prospective at that

<sup>3</sup>The fair value disclosures would not apply to private companies electing to use intrinsic value.

<sup>4</sup>All entities currently are required to present the disclosures specified in Statement 123. A comparison to the original disclosure requirements of Opinion 25 would not be relevant.

<sup>5</sup>An in-the-money option has an exercise price lower than the market price of the shares, an at-the-money option has an exercise price equal to the market price of the shares, and an out-of-the-money option has an exercise price greater than the market price of the shares.

time, it continues to apply the same accounting to past awards and to awards granted in 2004 and applies the accounting requirements of the ED to new awards. If the company previously chose the prospective transition method, the ED effectively overrides that decision by

requiring the modified prospective method now.

### Cash Flow Statement

The income tax benefit from option exercises can substantially reduce or eliminate a company's current tax liability. Under FASB Statement No. 95, *Statement of Cash Flows*, and EITF

Issue No. 00-15, the entire tax benefit, whether recorded in earnings or additional paid-in capital, is an operating cash flow. Under the ED, the tax benefit recorded as additional paid-in capital will be a financing cash inflow rather than an operating cash inflow.

## What Should Companies Do in Response to the ED?

The issuance of the ED and the likelihood that the final Statement will be similar to the ED is leading some companies to reconsider the design of their equity-based employee plans. This section provides information on some steps to take and points to keep in mind.

### 1. Assess the impact on your company.

The proposed changes in accounting will affect companies differently depending on a wide range of factors, such as the current use of employee stock plans, the stage of development, risk profile, and need for entrepreneurial talent. Companies need a clear understanding of these factors, along with their objectives, so they can respond appropriately to the effects of the proposed accounting changes on their particular facts and circumstances. Companies that have not already done so should take steps now to assess the impact of the proposed accounting changes and consider what actions, if any, should be taken to mitigate that impact.

In making that assessment, companies should not overreact to the proposed changes. A compensation charge for stock options is unlikely to have the adverse effects feared by the FASB's strongest critics. Pro forma earnings and earnings per share on a fair value basis have been disclosed for 10 years. Shareholders, analysts, creditors, and others already know in general terms the impact that the ED will have on reported earnings. Those companies that voluntarily adopted the fair value method over the past two years experienced no discernable impact on their share prices. Furthermore, because most companies will be adopting the final Statement at about the same time, no company will be at a disadvantage relative to its peers.

It is also worth recalling that dire predictions for prior FASB Statements have not come to pass. FASB Statement No. 2, *Accounting for Research and Development Costs*, did not decimate research and development activities. FASB Statement Nos. 87, *Employers' Accounting for Pensions*, and 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, did not result in the wholesale elimination of defined benefit pension plans or retiree health care plans. It is doubtful that a compensation charge for stock options, particularly one broadcast so long in advance with the pro forma disclosures, will cause the wholesale elimination of broad-based equity plans for employees. We believe shareholders will continue to support well-designed equity plans regardless of the accounting.

### 2. Respond to the ED.

The comment letter deadline for the ED is June 30. After June 30, the FASB will evaluate the comments received and consider what changes it should make to the ED before issuing a final Statement. The ED is long and raises many issues for respondents, but it is not necessary to respond to every issue. A company may choose to respond to as many or as few issues as it wishes. As with any comment letter to the FASB, responses that explain the basis for the company's views have greater impact than letters that express opinions without supporting rationale.

In addition, the FASB plans to hold public roundtable meetings on June 24, 2004, in Palo Alto, California, and June 29, 2004, in Norwalk, Connecticut. The roundtable meetings give participants an opportunity to present their views directly to Board members and answer questions. Any individual or organization desiring to participate should notify the FASB by sending an email to [director@fasb.org](mailto:director@fasb.org) by May 17, 2004, specifying the desired location.

### **3. Carefully weigh the consequences of changes in option plans.**

Some compensation consultants have suggested that companies accelerate the vesting of all outstanding stock options during 2004 so that there will be no unvested awards to account for in 2005 under the fair value method. Some consultants further recommend that companies grant several years' worth of fully vested stock options during 2004 and then grant no options after the effective date of the final Statement to avoid recording compensation expense. We believe strategies such as these should be evaluated carefully for possible negative consequences. Employee options have vesting provisions for a reason—to provide an incentive to remain employed and provide top-notch service. Similarly, granting options annually to high performers serves as a performance incentive. Accelerating vesting or accelerating grants may undermine those incentives.

It is appropriate to take a fresh look at compensation strategies in light of the pending new accounting guidance, but decisions should be driven primarily by what strategies provide the best incentives for employee performance and best align the interests of employees and shareholders. Accounting and income tax objectives, while important, should be subordinate to sound compensation objectives.

### **4. Consider alternative compensation strategies.**

Under Opinion 25, zero compensation is recorded for options with a fixed exercise price equal to market price at date of grant and no performance conditions. Many companies like that accounting result, which has helped to make such options the most common form of equity-based employee award. However, Opinion 25 also acts as a straightjacket, because modifications to make options more effective incentives usually result in variable accounting and exposure to large and uncontrollable compensation charges if the stock price increases. Thus, Opinion 25 deters innovations in option design. Under the ED, compensation is measured at grant date for a broader variety of awards, creating a more level playing field for different option features, for example, performance conditions and exercise prices that are higher than the market price at date of grant.

Under Opinion 25, any performance condition other than employee service delays the measurement of compensation until the outcome of the condition is known. The only type of performance incentive that is at all widespread under Opinion 25 is the time-accelerated option or restricted share. Under these arrangements, vesting is accelerated if the performance condition is achieved, but the award will vest based solely on employment (for example, at the end of 10 years) if the performance condition is not achieved. Because the time-based vesting undermines the incentive effect of the performance condition, time accelerated plans likely would not exist were it not for Opinion 25. The ED permits companies to measure compensation at grant date for equity awards with performance conditions.

One of the criticisms of traditional options is that they can reward mediocre performance. If a company grants its CEO a 10-year option on 100,000 shares of stock with an exercise price of \$10 per share (market price on date of grant), and its stock price appreciates at 4% per year for 10 years, the CEO has a profit of about \$480,000 at the end of 10 years. Given that the shareholders could have earned 4% per year in U.S. Treasury bonds, some critics believe that is an excessive reward. Compensation consultants have developed a number of proposals to mitigate this deficiency of traditional options. Here are several of those ideas and a summary of how they affect the accounting under Opinion 25 and the ED.

- *Performance-based vesting.* Exercise of the options is conditioned on meeting specific company performance criteria, such as market share growth, growth in income from continuing operations or earnings per share, or some other

measure. Under Opinion 25, the number of share is not fixed, so measurement of compensation is delayed until the performance conditions are met (variable accounting). Under the ED, compensation expense would be measured at the grant date.

- *Premium price options.* Grant options with an exercise price of \$15 per share, a 50% premium over the current stock price. If the share price doesn't appreciate by at least 50% (thereby outperforming U.S. Treasuries), the CEO has no profit on his options. Under Opinion 25, this option also has zero compensation. Although it is more favorable to the shareholders and less generous to the CEO, the compensation expense is identical to the traditional option. Under the ED, a \$15 option would have lower fair value and lower compensation expense than a \$10 option.
- *Indexed price options.* Grant options with an exercise price of \$10 per share that increases 4% each year. If the share price doesn't outperform U.S. Treasuries, the CEO has no profit on his options. (The option price also could be indexed to a stock market index or to the rate of return on peer companies' shares.) Under Opinion 25, the exercise price is not fixed, so the measurement of compensation is delayed until exercise date. Under the ED, an option with an indexed exercise price would be measured at grant date and would have lower fair value and lower compensation expense than a fixed \$10 option.
- *Stock price hurdle.* Grant options with an exercise price of \$10 per share that only can be exercised if the company's share price exceeds \$15 per share for 30 consecutive trading days. If the share price doesn't appreciate by at least 50%, the CEO can't exercise, and can't profit from his options. Under Opinion 25, there is an uncertainty about the CEO's right to buy the shares for a reason other than his service. As a result, the measurement of compensation is delayed until the stock price hurdle is satisfied, resulting in compensation expense of at least \$500,000 if the option does become exercisable. (The compensation expense could be higher if the share price is higher than \$15 on the 30th trading day.) Under the ED, an option with stock price hurdle would be measured at grant date and would have lower fair value and lower compensation expense than a fixed \$10 option.

These are just a few of many creative ideas compensation consultants have developed for better aligning the interests of employees and shareholders. Variable accounting under Opinion 25 acts as a significant deterrent to implementing these ideas. If the FASB moves forward with this project, companies should consider changing their plans to take advantage of the expanded ability to measure compensation at grant date.

##### **5. Explain any changes in compensation strategy to investors.**

In response to criticisms of perceived excessive option grants in the late 1990s, some companies have switched to restricted stock awards, and some investors may erroneously conclude that this strategy is preferable for all companies. We still remember that 15 years ago critics called restricted stock "pay for pulse" and said that large restricted stock grants were a sign that management was pessimistic about the company's stock price. At that time, critics touted options as the performance incentive alternative to restricted stock. Now options are falling out of favor, and restricted stock is back in vogue.

The key mission for boards of directors is to select the goals that management and employees should strive to achieve, and then craft equity plans that attract and retain qualified personnel, spur achievement of those goals, and align the interests of employees with shareholders. The establishment and communication of the goals and the tailoring of equity awards to those goals are paramount. Absent thoughtful goals and linkage of the awards to the goals, neither restricted stock nor options are a panacea.

## Financial Reporting

### For More Information

If you would like further information or to discuss the implications of the matters discussed in this *Financial Reporting* letter, please contact the BDO Seidman engagement partner serving you or one of the following partners: Ben Neuhausen, Andy Gibson, or Jim Blinka.

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