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Financial Reporting Highlights

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Accounting for Share-Based Payment

Many of the largest public companies got a temporary reprieve on FASB Statement 123(R), but issues identified by early adopters can help other companies.

When the FASB released Statement No. 123(R), *Share-Based Payment*, the Board's expectation was that large public companies would adopt the standard in the second half of 2005, six months before smaller public companies and private companies. But the SEC leveled the playing field in April 2005 by effectively providing a six-month reprieve for the larger calendar year companies. Now companies of all sizes are required to adopt the standard in 2006. The experiences of early adopters may help pave the way.

What are the main changes required by Statement 123(R)?

The main focus of Statement 123(R) is on awards to *employees*. The Statement applies to transactions in

which a company grants shares of common stock, stock options, or other equity instruments to its employees. Included in this category are restricted stock, share-settled appreciation rights (SARs), cash-settled SARs, and employee stock purchase plans.

Five key changes made by the Statement are summarized below:

1. Statement 123(R) requires that the fair value of stock options and other share-based compensation be deducted from earnings and shown as an expense in the financial statements. Formerly, the information was required in the footnotes.
2. With rare exceptions, Statement 123(R) indicates that the *intrinsic value method* of accounting can no longer

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be used to measure stock-based compensation awards. Instead, the *fair value method* must be used.

The intrinsic value method provides a simple measure of what an employee would get if he or she cashed in an option. The value is zero if the exercise price equals the price of the underlying share at the grant date. A prior accounting standard, APB Opinion No. 25, *Accounting for Stock Issued to Employees*, allowed the use of this method for expense recognition, resulting in zero expense for many awards of stock options.

The fair value method required by Statement 123(R) demands assumptions about future conditions because it requires companies to take into account the time value of options. In effect, this is the value to a hypothetical outsider who would take into account the probabilities of future outcomes, including the probability that the stock will go up in value during an option's life.

3. Under Statement 123(R), substantially all plans are considered compensatory, with the result that companies must recognize compensation cost for employee services received in exchange for equity instruments. Opinion 25 treated a significant number of qualified broad-based stock purchase plans as non-compensatory.

4. When applying the fair value method, the accounting for compensatory plans depends on whether the rights under the plan constitute equity interests or liabilities. A key difference is that the fair value of a liability award is reestimated every period from grant until exercise; whereas for equity awards the fair

value is estimated only once, at grant date.

For awards classified as equity, the compensation cost is measured at the estimated grant-date fair value of the award. Compensation is accrued for the awards expected to vest, based on estimated forfeitures and the expected outcome of certain conditions that affect vesting. The cost is recognized over the requisite service period (usually the vesting period). Compensation cost is adjusted to reflect actual forfeitures. Forfeited awards generally result in no compensation cost.

5. Most of the guidance in Statement 123(R) applies to both public and nonpublic companies, but some provisions apply only to nonpublic companies. For example, nonpublic companies can use alternative valuation methods not available to public companies.

What judgments are needed in expensing share-based payment?

Although it may seem a simple matter to take a number from the footnotes and move it into the statements, the standard has been plagued by controversy and fraught with implementation issues. Three key questions that companies may need to ask themselves are as follows:

1) *Has the company accurately determined if the plan creates a liability or equity?*

Awards are classified as liabilities if they have one or more of the following traits: (a) they possess conditions or features indexed to something other than a market,

performance or service condition, (b) they require a company to pay an employee (either on demand or on a specified date) cash or other assets, (c) they are exchanged for mandatorily redeemable preferred stock or another instrument that, after the award is exercised, would be classified as a liability under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, or (d) they have repurchase features that would permit an employee to avoid assuming the risks and rewards normally associated with stock ownership.

If an award is not classified as a liability, then it is classified as equity.

2) *Has the company chosen the most suitable pricing model and most accurate assumptions?*

The Statement provides that companies should use valuation models if suitable market prices are not publicly available. The best-known families of models are lattice (for example, binomial) and closed-form (for example, Black-Scholes) models. Both require assumptions about forward-looking data, such as expected option terms (i.e., the length of time employees will hold options before exercising them) and expected future volatility, (i.e. the degree to which the price of the company's shares fluctuates in the marketplace).

When choosing between the two types of models, the important considerations include the facts that the Black-Scholes model is generally easier to use and audit, while the binomial model provides more flexibility to address unique aspects of employee options.

3) Has the company made the right choice of the alternative methods available for private companies?

Nonpublic companies have some simplified alternatives. For liability awards, they can measure the compensation cost of awards at intrinsic value each period through the date of settlement. For equity awards (and for liability awards if they don't choose intrinsic value), they can use a calculated value method in which the volatility assumption is based on an appropriate industry-sector index. The minimum value method, which uses a volatility assumption of zero, is no longer permitted.

Will users of financial statements understand and accept the expense?

Some level of confusion is expected. This is based on the experiences of early adopters and the mixed reactions of the Wall Street securities analysts who follow larger public companies.

At least one major company that early adopted Statement 123(R) has announced a formal SEC inquiry into the way it announced its adoption of the standard. The problems surfaced because the per share impact given to analysts differed from the actual per share impact later reported to shareholders.

In addition, analysts disagree on the usefulness of taking the fair value compensation numbers from the footnotes and putting them in the income statement. Some analysts have said their forecasts will follow the GAAP treatment. Others have been openly skeptical of the largely

subjective nature of the forward-looking assumptions required under Statement 123(R). These analysts say they prefer to add back the expense subtracted for accounting purposes, and they will use pro forma earnings that exclude the options expense. As a middle ground and interim measure, still others say they will provide forecasts both with and without options expense, at least until the end of 2006.

Arguably one factor that has fueled the skepticism among analysts and others is an early report involving a study of Russell 1000 companies conducted by Nashville-based research firm New Constructs. A key finding of the study is that one in five companies had revised their volatility assumptions downward in 2004, the year before they expected to start expensing options. As a result, these companies were able to significantly lower their options expense for the succeeding year. (Cutting through the complicated models, the underlying logic is simple: Lower volatility means a lower probability that an option will land deep in the money, and that in turn lowers the estimated fair value at the grant date.)

The SEC staff cautioned registrants that employee compensation from share-based awards should be classified in the same line on the income statement as other forms of compensation. Also, if a company chooses to present pro forma earnings excluding share-based compensation, that is a non-GAAP measure that excludes a recurring expense and would be subject to the SEC's disclosure requirements.

What should companies disclose about accelerated vesting of share-based payment awards during 2005?

SEC Staff Accounting Bulletin (SAB) 107 reiterates the disclosures recommended by the SEC staff at the 2004 AICPA Conference on Current SEC Developments—disclosure that vesting was accelerated, the effect on recorded and pro forma compensation in 2005, and an explanation of the business reasons why vesting was accelerated.

What are the special challenges and solutions for smaller public companies?

The skepticism about meaningful estimates of fair value may be especially acute when it comes to the numbers reported by smaller public companies. A small change in the assumptions can make a big difference in the amount expensed, and the assumptions can be especially troublesome for smaller public companies in at least four areas.

1. *Expected volatility.* Smaller public companies may not be able to use historical data as a benchmark for estimating expected volatility. This is especially true of thinly traded companies. As a workaround, these companies may wish to use weekly or monthly quotes instead of daily ones to calculate their historical volatility. Then too, they may wish to incorporate data from similar companies at the same stage of their life cycles.
2. *Estimated forfeitures.* Like other companies, smaller public companies

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must estimate forfeitures. Typically, this calculation takes into account an assumption about the number of employees who will leave before their options vest and thereby forfeit their awards. These can be difficult estimates for smaller public companies because they have granted options to relatively fewer people, and they don't have a big enough sample from which to draw statistically valid inferences. As a result, these companies may wish to aggregate their data with that of other companies in similar circumstances.

3. *Expected terms of options.* Statement 123(R) requires assumptions about the length of time employees will hold options before exercising them. SAB 107 provides a shortcut for 2006 and 2007 under which a company may use an arithmetic average of the time elapsed between vesting dates and expirations dates. Companies may wish to consider the shortcut while accumulating their own data about employee exercise behavior. At the end of two years, they may have enough company-specific data; if not, they may wish to look for data on comparable companies.
4. *Separate employee groups.* Companies are required to stratify their assumptions based on data from separate groups with different vesting or exercise patterns, (e.g., executives and rank-and-file employees). Smaller public companies in which options have not been widely distributed may need to assess whether there are sufficient grant recipients to break down the employees into

separate groups and get a meaningful result.

What lessons can companies learn from the experiences of larger public companies?

Smaller public companies can benefit from the experiences of larger public companies, but the lessons learned are only partly reflected in the accounting literature. As a result, accountants may need to expand their reading lists to benefit fully from a new process the FASB has put in place for informal review of implementation issues on accounting for share-based payment.

1) How can companies learn from the implementation issues raised by others?

The FASB's new process for identifying implementation issues revolves around a resource group comprised of preparers, auditors, and consultants, with observers from the SEC and PCAOB staffs. Similar in some ways to the EITF, the resource group has as its objective the timely resolution of emerging issues, with an emphasis on identification of issues that may require more guidance from the FASB.

For questions that were not referred to the Board for additional guidance, companies can consult the minutes of meetings of the FASB's resource group. The group met three times in 2005. Summaries of the meetings are available on the website of *Financial Executives International*.

2) Can companies simplify the accounting for the income tax effects of share-based payments?

Questions have arisen about the income tax effects because the tax deductions for share-based compensation are based on intrinsic value and taken at the time of exercise (options) or vesting (restricted stock).

Companies accrue deferred taxes for tax-deductible share-based payment awards as they accrue the accounting compensation expense, but the actual tax benefit realized typically differs from the deferred tax benefit.

If the actual tax benefit realized exceeds the deferred tax benefit (a "windfall"), the excess is credited to capital. If the actual tax benefit realized is less than the deferred tax benefit, the shortfall is offset against prior credits to capital. If the prior credits are insufficient, the shortfall is charged to income.

To simplify these calculations, Statement 123(R) permits a pooling of amounts that are reflected in additional paid-in capital (the APIC pool). To many companies' surprise, the beginning balance of the APIC pool is not the actual amount the employer credited to shareholders' equity in prior years. Instead, it is the hypothetical amount that the employer would have credited to capital since 1995 if it had followed the fair value method of original Statement 123. Because companies may not have the information needed to establish the beginning balance of the APIC pool, the FASB issued FSP FAS 123(R)-3, "Transition Election Related to Accounting for the Tax Effects of Share-Based

Payment Awards,” to provide an alternative elective “shortcut” transition method for calculating a company’s historical pool of windfall tax benefits upon its adoption of Statement 123(R).

3) Can companies simplify their accounting for grants to retirement-eligible employees?

Questions have arisen about grants to retirement-eligible employees because Statement 123(R) requires that compensation expense be recognized over the period when services are provided by employees.

When applied to grants to retirement-eligible employees who are permitted to retain their awards upon retirement, this requirement means that the company must accrue compensation over the period from grant date to the earliest retirement date. This represents a change from prior practice under which many companies accrued the compensation over the stated service period, and it may require systems upgrades to track awards granted to retirement-eligible employees.

To help simplify the accounting, the SEC staff indicated that companies meeting certain conditions for past practice should apply this require-

ment prospectively to new grants awarded after adoption of the standard. Those companies should continue to apply their historical accounting policy for previous awards by accruing compensation over the stated service period, with appropriate disclosure.

4) Can companies simplify their accounting for share-based compensation included in inventory or self-constructed assets?

In SAB 107, the staff noted that many companies may not yet have integrated systems that accumulate share-based compensation with their cost accumulation systems for inventory or for self-constructed assets. The staff noted that it would be acceptable to make reasonable estimates of the amount of share-based compensation that should be capitalized in these assets rather than incurring costs to immediately integrate these systems.

In addition, the SEC has provided guidance on valuation issues in SAB 107 and in a report by the Office of Economic Analysis on the evaluation of various market-based approaches for estimating the grant-date fair value of employee stock options.

Basics and Best Practices

What’s Required. Calendar-year companies must adopt Statement 123(R) in 2006. This means first quarter 2006 for public companies and as of the beginning of the year for non-public companies. As part of adoptions, companies should:

- Test any software programs or spreadsheets used to develop accounting entries for compliance with the requirements of the Statement.
- Estimate forfeitures on all outstanding awards and accrue compensation going forward based on estimates of awards that will vest.
- If the outstanding grants include awards with graded vesting, decide whether to use the straight-line method to accrue compensation in 2006 and future years.
- Disclose the impact of adopting Statement 123(R).

What’s Voluntary. To go beyond the minimum, companies should:

- Read the minutes of the meetings of the FASB resource group.
- Evaluate the need for systems upgrades or data on comparative companies.
- Monitor the reactions of users of financial statements.
- Reevaluate key assumptions, such as volatility assumptions, prior to adoption of the standard and exercise care in communicating any revisions.
- Carefully communicate the effects of adoption, especially in a period for which the company is reporting earnings results that might be seen as disappointing.

This document was excerpted from BDO Seidman’s February 2006 *Financial Reporting* letter, *2005 Accounting Year in Review*. To read the full text of the letter, please visit <http://www.bdo.com/about/publications/assurance/2005-YELtr-2-06-2.pdf>.