

January-February 2009

Journal of  
**RETIREMENT  
PLANNING**

Published Bimonthly by CCH, a Wolters Kluwer business

**Recent Developments in Accounting  
for Equity-Based Compensation**

**Introduction to Elder Law**

**What We Can Learn About  
Retirement Investing from Our Grandparents**

**What Lies Ahead in Washington: Thoughts on  
Upcoming Legislative Initiatives by the New  
Obama Administration and the 111th Congress**

**Defined Benefit Plan Funding, PBGC  
and the Economy**

**Qualified Personal Residence Trust**

**CCH Tax Briefing: American Recovery  
and Reinvestment Act of 2009**

# Recent Developments in Accounting for Equity-Based Compensation

*By Alan A. Nadel and Derrick Neuhauser*

Since the implementation of FAS 123R in 2005, there have been a number of developments which affect the accounting treatment for equity compensation. Alan Nadel and Derrick Neuhauser discuss the major changes that companies and practitioners should be aware of.

**W**hen structuring equity-based compensation programs, one area that is often overlooked is the financial accounting treatment of these arrangements. Most HR executives and their advisers are well aware of the income tax and securities laws that affect these plans, but may not always consider the relevant financial accounting rules. Since 2005 companies have been subject to the rules of FAS 123R with respect to the accounting for equity compensation provided to employees. These rules differ in significant ways from those that were applicable under the prior accounting treatment set forth in APB 25 and related guidance.

Since the implementation of FAS 123R there have been a number of developments that either clarify or change the accounting treatment for certain transactions involving equity compensation. Some of these changes have been in the form of additional FASB guidance involving FAS 123R whereas others are a result of changes involving other accounting issues that indirectly affect equity compensation. Companies and their advisers should be aware of these changes

because they may affect the design or administration of their equity programs.

## Overview of Accounting Guidance

FAS 123R was issued in 2005 as a revision of the accounting treatment that was previously in existence since 1972. It represents a change in the way companies must recognize the cost of their equity-based compensation programs. Unlike the previous accounting treatment, which usually resulted in no expense for stock options granted with an exercise price equal to the value of the underlying shares, FAS 123R requires employers to recognize a value for all equity grants made to employees. Much of that guidance relates to the valuation of stock options and other share-based awards, but also addresses how the fair value of these awards is amortized across different accounting periods as well as a variety of other special issues. Most practitioners are familiar with the rules of FAS 123R, but may be unaware of significant developments that have occurred since its issuance four years ago.

**Alan A. Nadel** is a Managing Director with Strategic Apex Group LLC in New York City.

**Derrick Neuhauser** is a Senior Manager with BDO Seidman LLP in Chicago.

## Grant Date

The determination of the exact date that equity grants are considered to have been made to em-

ployees has never been clear. Various dates would seem to be appropriate:

- Recommendation by the compensation committee of the size and other relevant terms of the specific grant
- Approval of the recommended grants by the board of directors
- Transmission of the board/committee's grant decision to the corporate secretary
- Recording of the board/committee minutes
- Notification of the board/committee's action to the company's outside stock administrator or agent
- Processing of the award following grant, including entry into the stock plan administrative software
- Preparing the associated paperwork (electronic or otherwise)
- Actual issuance of options or shares pursuant to company's stock register
- Transmission of relevant information to company's human resources department or payroll department
- Communication of relevant grant information to the participating employee
- Receipt of employee signature or other acknowledgement

Determining the exact grant date generally has not been an issue for income tax purposes, although it may be important specifically with respect to Incentive Stock Options (ISOs granted at a discount (determined at the grant date) are deemed to be non-qualified options subject to withholding tax and are problematic for purposes of Code Secs. 162(m) and 409A of the Internal Revenue Code). The more important date for income tax purposes is the date that an equity award becomes vested, is transferred to, or is exercised by covered employees because that is when taxation occurs. Consequently, there has been little guidance from the IRS and few relevant court cases with respect to the timing of the grant date.

From an accounting viewpoint, however, there is greater concern about the grant date because equity grants are valued for purposes of determining expense as of the date they are deemed to be granted. The value at the date of grant is what is used for expense recognition purposes during the related service period. Notwithstanding post-grant fluctuations in the value of the underlying shares or other changes in the factors comprising the assumptions used for valuation purposes, the initial grant value continues to be used for expense recognition purposes. Subsequent events that constitute modifi-

cations may trigger additional expense, but the initial value is not revised based on those events.

This has become an even bigger issue recently in light of the number of cases in which companies have backdated their stock options. Using a variety of methods and valuation dates, some companies granted option awards based on a date that gave their employees an exercise price for those awards that was lower than the value of the underlying shares at the actual date of grant. Regardless of the approach used to backdate stock options, the failure to properly account for the stock options may have resulted in an overstatement of income. In those cases, it may be necessary for some companies to revise their financial statements to reflect additional expense for the excess of the fair value of the options at the actual grant date over the exercise price stated in the option grants. As we have seen in recent months, stock values can vary significantly over very short periods of time. Consequently, selecting the appropriate grant date may have a significant effect on the value of the option award and the resulting cost to the company.

In FASB Staff Position FAS 123R-2, the FASB provided guidance in determining the precise grant date for equity awards in accordance with FAS 123R. The FASB position is that the grant date occurs when there is a "mutual understanding" between the employer and employee about the key terms and conditions of the share awards. A mutual understanding is presumed to occur if:

- The grant by the company is unilateral and the recipient has no ability to further negotiate key terms and conditions of the awards
- Key terms and conditions of the awards are expected to be communicated to recipients within a relatively short time period from the date of approval (in accordance with the company's corporate governance provisions)

While there is no further explanation by FASB about what is a relatively short time period, the typical practice by most companies of communicating the details of equity awards to employees within a few days or a week following approval by the board or compensation committee should be sufficient to ensure the approval date as the date of grant. In contrast, holding onto the awards for a few months, whether through administrative error or in order to "see how things go" before communicating them to employees, would likely fail to satisfy the "short time period" requirement and would result in additional changes to the financial statements.

## Earnings Per Share

The calculation of earnings per share would not seem to be a complicated matter; just divide the company's net income for the year by the number of outstanding shares. As with most other things, however, the accounting methodology for determining earnings per share is not as easy as it first seems.

Many CPA candidates have suffered through the various rules for calculating EPS. Fortunately, a full discussion of EPS calculations is beyond the scope of this article. What is important to remember for our purposes is the treatment of stock options in the EPS calculations. Although options provide certain rights to shares, they in fact are not shares. The accounting literature recognizes this difference and has developed an approach for converting options into shares for purposes of the EPS calculation. Using the "treasury method", vested options are deemed to be exercised and outstanding when calculating EPS. But instead of recognizing all those shares, the company is deemed to have received the exercise price of those options and utilized all the cash to repurchase shares in the open market. The treasury method has been in use for many years.

FASB Staff Position EITF 03-6-1 clarifies how the payment of nonforfeitable dividends on share-based awards affects the EPS calculation. Essentially, the payment of these nonforfeitable dividends turns the awards into "participating securities." This requires that the "two-class method" must be used with respect to those dividends rather than the treasury method. The net effect is a decrease in basic earnings per share because the two-class method results in more shares than under the treasury method. It should not make a difference in calculating diluted earnings per share. It should be noted, however, that this approach is to be used only with respect to awards that are settled in shares rather than in cash.

Another development affecting the calculation of EPS results from the recent FASB 128 exposure draft. The FASB clarified that awards that are classified as liability awards (typically cash-settled awards) will not dilute EPS. Moreover, there are favorable adjust-

ments to the calculation of EPS using the treasury method. This essentially assures that liability awards will not adversely affect EPS. Also, companies may assume that awards will be settled in shares unless those awards are subject to liability accounting.

## Mergers and Acquisitions

FAS 123R provides specific guidance in connection with the valuation and expense recognition of share-based awards. While the basis of valuation is tied to the fair value of the award at initial grant, FAS 123R provides for a new valuation in the event the award is modified. Although the modification may take various forms, the most common type relates to the disposition of stock options and other share awards in the course of a corporate merger or acquisition. A common occurrence is the continuation of employees' share awards following the transaction, but replacing the target company's shares with those of the acquiring company. While often viewed as a simple replacement transaction with few or no income tax effects

**Using a variety of methods and valuation dates, some companies granted option awards based on a date that gave their employees an exercise price for those awards that were lower than the value of the underlying shares at the actual date of grant.**

under Code Sec. 83, FAS 123R treats the exchange as a modification.

A modified award is treated as the exchange of the original award for a new award. Additional compensation expense must be recognized (1) for any incremental fair value of the new award over the fair value of the canceled award and (2) for any remaining compensation cost determined at the date of the original grant that has not yet been recognized as an expense. For these purposes the company must use the fair value of the award rather than its intrinsic value. The fair values are compared immediately before and after the modification (*i.e.*, the actual closing of the transaction). The total compensation cost recognized at the time of the transaction generally may not be less than the fair value at the date of grant.

In the case of a corporate transaction, the fair value of the acquirer stock options that are being issued are compared to the fair value of the target company stock options that are being replaced. If the new options

have a lower value than the old options, the fair value of the new options is split between purchase price (not an expense) and deferred compensation (to be recognized as an expense in the future). This split is based on the proportion of the vesting period that has passed as compared to the amount of time remaining in the vesting period. If the new options have a greater fair value than the old options, the amount equal to the fair value of the old options is split between purchase price and deferred compensation. Additionally, the entire excess of the new options over the old is recorded as deferred compensation by the acquirer. Any amounts recognized as deferred compensation are amortized as an expense by the acquirer over the remaining service period (usually the vesting period). No expense is recognized immediately at the time of the corporate transaction.

There has been a recent development affecting the accounting for share-based awards during a corporate transaction, although it has gone largely unnoticed. The accounting rules affecting business combinations (i.e., mergers and acquisitions) were amended in a variety of ways. One of the new provisions addresses the matter of share awards whose vesting is accelerated upon the occurrence of the business combination. If the acquirer is obligated under existing agreements to continue or replace the target employees' awards, no additional expense is recognized for those awards. On the other hand, if the acquirer replaces the target employee awards when there is no obligation to do so, the replacement awards are charged as an expense in the acquirer's future years' financial statements. This requires companies to determine at the time of the transaction whether they have been a long-standing obligation to replace such awards or whether this was something that arose only at the time of the transaction.

### **Repricing of Awards**

---

There has been considerable discussion recently about the exercise price of stock options and other

similar awards. As a result of the extensive upheaval in the public stock markets over the past year, many option awards have exercise prices that are far greater than the current price of the underlying shares traded in the public markets. These awards are usually referred to as being underwater or out of the money. While no one can predict the future, it seems very unlikely that stock prices will recover to their 2007 price levels any time soon. Many companies issued these awards as a means of motivation and to serve as incentives for employees. Because these awards are so far out of the money, they no longer serve their original purpose. There has been considerable discussion at many companies about repricing these awards so their exercise prices better reflect current market values of the shares and they have a reasonable chance of providing incentives for employees.

Companies should bear in mind that the accounting rules for awards that are repriced are different under the current accounting rules of FAS 123R as compared to the rules in effect prior to 2005. The repricing of an option under FAS 123R would be considered to be a modification of the award. As a result of the repricing, the company would compare the fair value of the award immediately before the repricing to the fair value immediately after and would be required to recognize an additional expense for this difference. Presumably, this additional expense would be recognized over the remaining vesting period of the repriced stock awards.

### **Conclusion**

---

Although the treatment of various equity awards under the accounting rules is the purview of accountants, those who design and administer these programs as well as attorneys who draft the related agreements should be aware of the impact of these rules. Many of the specific design features of these plans as well as subsequent events that occur may have significant accounting affects without raising any questions for legal or tax purposes.

This article is reprinted with the publisher's permission from the JOURNAL OF RETIREMENT PLANNING, a bi-monthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher's permission is prohibited. To subscribe to the JOURNAL OF RETIREMENT PLANNING or other CCH Journals please call 800-449-8114 or visit [www.CCHGroup.com](http://www.CCHGroup.com). All views expressed in the articles and columns are those of the author and not necessarily those of CCH.

Journal of  
**RETIREMENT  
PLANNING**

**PUBLISHED BY**



**CCH**

a Wolters Kluwer business

4025 WEST PETERSON AVENUE  
CHICAGO, IL 60646

**ADDRESS SERVICE REQUESTED**

**PRESORTED FIRST CLASS  
U.S. POSTAGE PAID  
CCH, a Wolters Kluwer business**