SEYFARTH SHAW

MANAGEMENT ALERT

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FASB Releases Proposed Rules for Accounting for Equity-Based Compensation

On March 31, 2004, the Financial Accounting Standards Board ("FASB") published an exposure draft, entitled Share-Based Payment, an Amendment of Financial Accounting Statements (FAS) No. 123 and 95 (the "Statement"), that will require accounting recognition of equity compensation costs. The Statement has been the subject of much debate and strong opposition, particularly by technology companies and venture capitalists, while a handful of companies have chosen to expense options in advance of the Statement's effective date. If the Statement becomes final, employers who follow generally accepted accounting principles (GAAP) and who compensate employees with "share-based payments" (stock options, equity appreciation rights or other equity-based instruments) will be required to recognize such payments as an expense on their income statement using a "fair value" approach. The Statement is likely to affect how employers compensate their executive employees generally, as well as the underlying value of such companies.

Background

Current accounting rules generally permit an employer to choose between two methods of accounting for equity-based compensation. Most employers choose the "intrinsic value" method under Accounting Principles Bulletin (APB) No. 25. Under this method, the amount to be recognized as an expense is the excess of the fair market value of the underlying share over the exercise price, usually determined at the date of grant. In the case of stock options, this method generally results in employers recognizing no expense since options are typically granted with an exercise price equal to fair market value.

Alternatively, employers can choose to apply the "fair value" method of accounting under FAS No. 123. Under this method, the "fair value" of the award is recognized as an expense. The fair value is generally determined through the use of a model (*e.g.*, Black Scholes), unless the stock or option being awarded is publicly traded. This method generally requires employers to recognize an expense, even for options granted at fair market value.

The favorable accounting results under the intrinsic value method have led many companies to provide their employees with large amounts of equity compensation, particularly in the form of stock options. As the value of these awards grew during the late-90s, and following the collapse of the stock market and the accounting scandals of recent years, investor groups complained that the intrinsic value accounting rules distort corporate income statements. That, together with the general trend of FASB to converge U.S. accounting standards with international standards, which currently require fair value accounting for share-based compensation, was the impetus for FASB to publish the Statement.

Exposure Draft Summary

The most significant change in the Statement is that it eliminates a public company's ability to choose the intrinsic value method rather than the fair value method of accounting for equity compensation. Instead, public companies would be required to apply the fair value method to share-based awards as of the date of grant. If the award vests over time, then the company recognizes the cost over the vesting period. This requirement could substantially impact companies' income statements.

The most problematic and controversial issue in accounting for share-based compensation using a fair value approach has centered around how options are to be valued. According to the Statement, awards will be valued using a model that takes into account a variety of factors, including exercise price, term, current price, expected volatility, etc. The Statement recommends that employers use a complex "lattice" or binomial model that considers volatility and probability of exercise over time, rather than a "closed-form" model such as Black-Scholes. Unfortunately, the ability of companies to choose alternative valuation models makes it likely that one of the key underlying goals investor groups had in connection with equity compensation – uniformity in accounting treatment – will not necessarily be achieved.

The Statement, however, may have the effect of making accounting a neutral factor in determining the design of the executive

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compensation. Under current accounting rules, there is a clear bias towards awarding stock options with a fixed vesting period, which generally produces no recognizable charges to earnings, as opposed to cash, restricted stock, stock appreciation rights or awards with performance-based vesting, since these latter awards result in charges to earnings. Since all types of share-based compensation will result in charges under the new rules, this bias may disappear.

Non-public Companies. Non-public entities will still have a choice to make, although they may no longer use the intrinsic value method as it exists today to measure the cost of the award. A nonpublic entity must make a policy decision as to whether to measure the cost of equity compensation based on the fair value at the grant date or the intrinsic value *at each reporting date until the options are exercised or otherwise settled* (similar to the current accounting rules for variable awards). While many private companies do not think that FASB's rules are relevant to them, these rules often do have an impact, particularly if a private company has loan covenants or other contractual provisions that may be related to earnings. It is generally expected or required that earnings for such purposes be determined in accordance with GAAP.

ESPPs. The Statement will have a significant impact on the accounting treatment for most employee share purchase plans (ESPPs). Under current accounting rules, these plans are not treated as compensatory and, therefore, no charges to earnings are required, if they are structured appropriately (*e.g.*, under FAS No. 123, the discount cannot exceed 5% and it must be based on the value at the time of purchase, not the lesser of the value at time of purchase or beginning of the purchase period). Under the exposure draft, the only way to avoid accounting for ESPPs as compensation is to structure the ESPP such that the terms are the same as are available to all holders of that class of shares, *i.e.*, to the public. Since this is unlikely to happen, the Statement is likely to limit the use of ESPPs as they exist today unless the Statement changes in the final version.

Effective Dates. The proposed effective date for the Statement is for fiscal years beginning after December 15, 2004, in the case of public companies and private companies that have adopted FAS No. 123. Other private companies would not be subject to the rules until fiscal years beginning after December 15, 2005. Assuming that the rules are not finalized until late in 2004, this will not give companies much time to revise their accounting methods before annual reports are due.

What now?

Until FASB finalizes these rules (not before the third quarter of 2004, but more likely not until the fourth quarter), the Statement remains only a proposal. Written comments are being accepted until June 30, 2004, and companies that will be affected are encouraged to submit comments. In addition, Congress is also considering legislation proposing different accounting treatment for share-based payments. In light of the complicated mix of strong opposition to the Statement by some groups and election year politics, any final rules governing the accounting treatment of these awards remain uncertain.

We encourage companies currently using share-based compensation techniques to begin reviewing how the new rules, if adopted, would impact their financial statements, in particular, with respect to awards that are currently outstanding, but have not yet vested, and ESPPs, and to determine whether there are any actions that, in the context of a company's compensation strategies, could be taken prior to the adoption and/or effective date of the Statement.

If you have questions about the proposed FASB rules and your compensation techniques, please contact the Seyfarth Shaw Employee Benefits Group attorney with whom you work or any Employee Benefits attorney listed on the website at www.seyfarth.com.

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