SEYFARTH SHAW

MANAGEMENT ALERT

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# FASB Finalizes Accounting Rules for Equity-Based Compensation

After extended debate regarding whether and to what extent there should be a charge to earnings for stock option grants and other equity-based compensation, and despite strong opposition, in particular, from technology companies, the Financial Accounting Standards Board (FASB) adopted final revisions to Financial Accounting Statement (FAS) No. 123, now referred to as "Share-Based Payment." Previously FAS 123 allowed a company to choose to account for equity compensation (including options) on a "fair value" method which requires a charge for all equity compensation including options or to continue to use the "intrinsic value" method under Accounting Principles Bulletin No. 25 which did not require a charge to earnings for most options (although it did require a charge to earnings for stock grants).

Once final, FAS 123 will require accounting recognition of most equity compensation costs, including the "fair value" of options granted to employees, by employers who follow generally accepted accounting principles (GAAP). Also covered by FAS 123 are new rules for "liability awards" - those awards the value of which is based on equity but which are paid in cash, such as stock appreciation rights and phantom equity grants. The new rules will particularly impact those industries, such as technology and bio-technology companies, that have relied heavily on stock options for compensating employees. There are some notable changes in FAS 123 from the proposed rules first circulated in FASB's Exposure Draft.

The "fair value" of an equity award is determined at the time the award is granted and is recognized as an expense over the service period (generally the vesting period). Fair value is generally determined through the use of a reasonable valuation model (unless the stock or option being awarded is publicly traded). Although the Exposure Draft indicated a preference for the binomial or lattice model, final FAS 123 eliminates any preference for a specific type of model, making either lattice method or Black-Scholes (as well as others) available.

## Effective Dates for the New Rules

- *Public Companies* - General - as of the beginning of the first interim or annual reporting period that begins after June 15, 2005 (i.e., the period beginning July 1, 2005 for many companies).
- *Public Companies Filing As Small Business Issuers* - as of the beginning of the first interim or annual reporting period that begins after December 15, 2005 (i.e., the period beginning January 1, 2006 for most small business issuers).
- *Non-Public Companies* - as of the beginning of the first annual reporting period that begins after December 15, 2005 (i.e., the fiscal year starting in 2006).

The new FAS 123 rules apply to all awards granted after the applicable effective date and to any awards modified, repurchased or cancelled after that date.

## Transitional Rules

FAS 123 offers the following three methods of transitioning to the new reporting rules:

- *Modified Prospective Method* - For periods beginning on or after the effective date, this method requires that an accounting expense be recorded for new and modified awards using the new FAS 123. The vested portion of previously issued and outstanding awards continue to be recognized under the prior provisions of FAS 123. As unvested portions of previously issued awards vest after the effective date, an expense will be recognized under FAS 123. The expense for earlier quarters of the first year are not restated. The first annual report for the year that includes the effective date will show an expense determined partially under the new FAS 123 rules and partially under prior rules. The two prior years' comparative costs are not restated. This method is required of all public entities and non-public entities that currently use the existing FAS 123 fair value method of accounting.

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- *Modified Retrospective Method* - Under this method, new and modified awards are treated as they are under the Modified Prospective Method, as are unvested awards after the effective date. However, unlike the Modified Prospective Method, the expense for the earlier quarters of the first year to which the new rules apply are restated using the old FAS 123 rules. The first annual report for the year that includes the effective date will show an expense determined partially under the new FAS 123 rules and partially under old FAS 123 rules. The two prior years' comparative costs are not required to be restated, but a company may elect to restate them using the prior FAS 123 rules. Public entities and non-public entities that currently use the existing FAS 123 fair value method may choose to apply this method to periods before the effective date.
- *Prospective Only Method* - Under this method, for periods beginning on or after the effective date, an accounting expense is to be recorded for new and modified awards using the new FAS 123. Prior quarters are not restated and unvested awards continue to be accounted for under the method of accounting that was being used prior to the effective date. This method is permitted only for non-public entities that do not currently use FAS 123 fair value accounting.

FASB is encouraging early adoption of the new rules, as well as the use of the Modified Retrospective Method.

## Special Rules

*Liability Awards* - Liability awards include compensation awards the value of which is based on the employer's equity, but which are settled in cash or property other than shares, such as phantom equity and cash-settled stock appreciation rights. Unlike a regular equity award, the fair value of a liability award is re-determined each quarter during the service period and the expense for the quarter is adjusted. This makes liability awards much more volatile, and in the case of non-public companies that may require more frequent valuations, even more expensive.

*Employee Stock Purchase Plans (ESPPs)* - This is one area that has undergone significant revision from the original proposal. Generally, a broad-based employee share purchase plan that limits the discount to 5% or less of market price determined on the date of purchase will not give rise to recognizable compensation for GAAP purposes. This means that those ESPPs that base the purchase price on the lower of the market price at the beginning or the end of the purchase period will either need to be amended to determine price on the last day only, or a compensation cost will need to be recognized.

*Modifications of Awards* - Modification of an equity award is treated as the exchange of the award for a new award, and the expense to be charged increases if the new award's fair value is greater than the fair value of the original award immediately before the modification. Therefore, a modification which does not change the fair value of the award should not negatively impact the expensing of the award.

*Reload Options* - Each "reload" is treated as a separate option grant and must be separately accounted for, making reload options expensive.

*Performance Awards* - Under prior accounting rules, awards which vested over a period measured by something other than time (for example, an option that vested when the company's EBITDA reached a certain level) were not considered "fixed" awards and, therefore, were subject to "variable" accounting, meaning that a compensation expense was recognized quarterly based on the difference between the then market value and the exercise price. Under the new FAS 123, performance awards are not subject to more detrimental accounting treatment than other types of awards.

## Planning the Conversion to Full Value Accounting

These new accounting rules can be very complicated and confusing. In addition, in those industries in which stock options were heavily relied upon to compensate employees, the new rules will have a major cost impact. Public companies and those private companies that use GAAP accounting should begin planning their conversion to FAS 123 if they have not already done so.

Different valuation models may be more or less optimal for a particular company. Certain types of changes to existing kinds of grants may help control costs - such as granting shorter term options. Other companies may desire to switch kinds of equity compensation awards, for example, from option grants to restricted stock awards, since accounting expense will no longer be a distinguishing factor. Because the new rules will impact earnings, companies should not only review the design of their equity plans, but also any cash incentive plans to ensure that there are no unintended consequences under these types of plans. Also, changes in equity-based awards and plans can be affected by new Internal Revenue Code Section 409A and its rules for deferred compensation. See our January 2005 Management Alert by clicking here.

*If you have any questions concerning FASB accounting rules' affect on equity-based compensation, please contact the Seyfarth Shaw LLP Employee Benefits or Corporate Group attorney with whom you work or any Employee Benefits or Corporate attorney on the website at www.seyfarth.com.*


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