

Buck's FASB Statement 123 Update:

FASB Releases Share-Based Payment Exposure Draft

On March 31, 2004, the Financial Accounting Standards Board (FASB) released its much anticipated exposure draft (ED) highlighting the proposed accounting rules for all "Share-Based Payment" compensation awards. The FASB intends to release its final standard in the fourth quarter of 2004, and require adoption for fiscal years beginning after December 15, 2004, for most companies. This paper summarizes the proposed accounting rules and discusses implications for companies using stock compensation.

FASB UPDATE

The new ED is an amendment of the original Statement 123 released in 1995, as well as certain other statements. It marks a critical juncture in the share-based award debate. The "intrinsic value" accounting method under Accounting Principles Board Opinion No. 25 (that resulted in earnings-charge-free accounting for traditional at-the-money stock options) will soon end. The proposed rules require publicly traded U.S. companies to adopt a "fair value" accounting method for fiscal years beginning after December 15, 2004, for all share-based awards. The proposed rule change is intended to provide a more level accounting playing field for share-based awards, provide more transparent information on the cost of such programs to shareholders and be part of a long-term move to converge standards with the International Accounting Standards Board (IASB). The table on page 2 summarizes the key provisions of the exposure draft.

SCOPE

In this ED, the FASB discusses the proposed accounting rules for share-based award transactions for employees and outside directors. The ED specifically does not address share-based transactions relating to non-employees and Employee Stock Ownership Plans (ESOP), but the FASB plans to address these transactions at a future date.

TIMING AND TRANSITION

The timing and transition guidelines for the proposed accounting rules are different for U.S. publicly traded and non-public companies. Publicly traded companies are required to apply the new rules in the first fiscal year beginning after December 15, 2004, (fiscal 2005 for calendar fiscal year companies, fiscal 2006 for non-calendar fiscal year companies). The ED also stipulates that publicly traded companies are expected to apply the modified prospective method of transition for all share-based awards granted or modified in the first

fiscal year of adoption and retrospectively for all unvested share-based payments granted or modified for fiscal years beginning after December 15, 1994.

Publicly traded companies are not permitted to restate prior financials under the modified prospective method.

BUCK NOTE: *This represents a significant change to the prior transition rules that allowed for a prospective-only transition. Companies will no longer be allowed prospective-only application — even if they voluntarily adopted the rules before the mandatory effective date.*

Non-public companies that have already used SFAS 123 for recognition or pro forma disclosures must abide by the same effective dates as mandated for publicly traded companies. The FASB has extended the effective adoption date to December 15, 2005, for non-public companies that currently apply the minimum-value method for share-based awards. These companies are required to apply the new treatment on a prospective-only basis. Unlike other companies, non-public companies using the minimum-value method are not obligated to accrue compensation costs for unvested awards granted prior to the effective date.

MEASUREMENT

The measurement basis is based on the classification of the share-based award:

- Equity (e.g., stock options, stock appreciation rights settled in shares, performance shares and restricted stock shares) will be measured on the grant date of the award (fixed accounting).
- Liability (e.g., stock appreciation rights settled in cash and cash unit plans) will be measured at the end of each quarterly reporting period (variable accounting).

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KEY PROVISIONS OF THE EXPOSURE DRAFT

How will publicly traded U.S. companies measure the compensation cost of employee equity grants?

Share-based award costs will be measured at the grant date using a fair value model. The compensation cost will be accrued over the requisite service period.

How will publicly traded U.S. companies measure the compensation cost of employee cash (liabilities) awards?

Liabilities or cash awards will be measured at fair value and will be recalculated each quarter until the settlement date (variable accounting).

What fair value models will be required to calculate costs for stock options and other share-based awards?

The FASB will permit companies to select a lattice (binomial) or closed-form (Black-Scholes) valuation model. The lattice (binomial) model is the FASB's preferred valuation approach.

How will companies measure the accounting impact of a share-based award that is modified after the grant date?

Additional incremental cost is accrued if the fair value of the award immediately after modification is greater than the fair value of the award immediately prior to modification.

Will Employee Stock Purchase Plans (ESPP) incur accounting costs under the proposed accounting rules?

Yes. ESPPs will generate a compensation charge if the purchase price for each share is discounted. The discount includes both explicit discounts and look-back features.

How are excess tax benefits recognized?

In situations where the realized tax deduction benefits are in excess of the compensation cost recognized, the result is a credit to additional paid-in capital for the excess tax benefit, and the associate cash flow is recognized as a financing cash inflow. In cases where the tax return deductions are less than the compensation costs recognized, the result is a write-off of the excess deferred tax asset previously recognized.

How will non-public companies measure the compensation cost of equity share options and liability (cash) awards?

Fair value is considered the preferred method by the FASB and will be required for all fiscal years beginning after December 15, 2005, for all non-public companies that do not currently use SFAS 123 for recognition or pro forma disclosure. Non-public companies that currently use SFAS 123 for recognition or pro forma disclosure will be required to apply the new rules in the first fiscal year beginning after December 15, 2004 — consistent with publicly traded companies.

How will non-public companies measure the compensation cost of equity share options and liability (cash) awards?

Non-publicly traded companies must measure share-based awards classified as equity instruments using the fair value based method (fixed accounting). Awards classified as liability instruments can be valued at fair value or intrinsic value, but regardless of the method selected, re-measurement at each reporting date is required (variable accounting).

Service, Performance and Market Conditions

The ED identifies three types of conditions that can affect the value of a share-based award: service, performance and market conditions. The table below provides definitions and examples of these three conditions.

Any of these conditions that affect the price, quantity or term of the award will have an impact on the award’s calculated value. However, if the condition only affects the vesting or exercisability of the award, it doesn’t have an impact on the calculated value, but does affect the method of cost amortization (see Attribution section).

Share-Based Payment Compensation Cost: Full Value Awards Settled in Shares

The compensation cost of full-value awards (e.g., restricted stock, performance shares or units settled in shares) is based on the common stock price of the underlying award on the grant date. If dividends are paid over the course of the vesting or performance period, publicly traded companies are not obligated to realize an incremental compensation cost, unless the full-value awards are canceled and the dividend payments are not reimbursed to the company. If dividends are not paid on the units/shares, the grant-date value of the award is reduced by the present value of the foregone dividends.

Share-Based Payment Compensation Cost: Appreciation Awards Settled in Shares

The compensation cost of appreciation awards (e.g., stock options, stock appreciation rights settled in shares) is based on the fair value of the award on the grant date. The fair value is estimated based on a lattice (binomial) valuation model or a closed-form

(Black-Scholes) model for recognizing compensation costs. Both models use the same six core inputs outlined above.

While the binomial model and the Black-Scholes model will yield substantially similar values given the same basic inputs, binomial has the ability to accept much more complex and varied assumptions. For example, while Black-Scholes can only accept one volatility, one risk-free rate and one dividend yield assumption, held constant over the expected holding period from grant to exercise, the binomial model has the flexibility to vary these inputs over the holding period from grant to exercise. Additionally, Black-Scholes can only calculate the value of an option that is exercised at the end of the expected holding period. Binomial can assume exercise at any point in time during the holding period, and the probability of exercise at any given point can be manually changed to reflect expected employee behaviors.

The ED does not require companies to select one valuation model. However, the ED considers the binomial model preferable to the Black-Scholes valuation model since it potentially provides a more “accurate” result based on more flexible inputs relating to:

- Future expected changes in volatility and dividend yields
- “Sub-optimal” employee exercise behaviors
- Value of early exercisability on dividend yielding stock
- Projected changes in business structure
- Macroeconomic trends

The FASB has stated that binomial is preferred because of this increased flexibility. While it is undeniable that a complex binomial

SERVICE, PERFORMANCE & MARKETING CONDITIONS:

Condition	<i>Definition: A condition affecting price, quantity, term, or vesting/exercisability ...</i>	<i>Price/Quantity/Term Example</i>	<i>Vesting/ Exercisability Example</i>
Service	<i>... based solely on an employee rendering service for a specified period of time.</i>	<i>Option price is halved every 12 months</i>	<i>Cliff vest at the end of 3 years</i>
Performance	<i>... based on both (1) an employee’s rendering of service for a time, and (2) performance against operational targets.</i>	<i>1X target if annual ROE < 15%, 2X target if annual ROE is 15%</i>	<i>Vest if annual ROE 15%</i>
Market	<i>... based on achievement of (1) specified price or intrinsic value of award, or (2) stock performance against an index.</i>	<i>Option price indexed to S&P 500 performance</i>	<i>Vest when stock price exceeds \$40</i>

model can be constructed to accept many varied inputs, it is premature to say that binomial is therefore more accurate for use in valuing employee stock options. However, this presupposes that these complex assumptions can be accurately established. Because these models call for predictive assumptions like expected stock volatility and expected employee holding and exercise behaviors, it becomes increasingly difficult to maintain accuracy as the number of inputs required increases.

In evaluating the appropriate valuation model, the FASB acknowledges that some companies may want to continue using the Black-Scholes valuation model if they do not possess reasonable data required to establish the more complex inputs required under a flexible binomial model. Unfortunately, the FASB does not provide much guidance as to what constitutes “reasonable” data — instead leaving it up to companies and their auditors to interpret case-by-case situations. Considering that the move from Black-Scholes to binomial is irrevocable, together with the fact that no major accounting firms have yet provided definitive guidance on how a complex binomial calculation will be audited, it makes sense for most companies to approach the switch to a binomial model with much caution. Until the FASB or the accounting firms

provide more information on the logistics behind binomial application, it may make sense for most companies to continue using the Black-Scholes model.

Share-Based Compensation Cost: Equity Awards Settled in Cash

In cases where publicly traded companies choose to grant liability awards, the compensation cost will be measured at the end of each quarterly reporting period. Appreciation awards settled in cash will be valued at the end of each quarter using the binomial or Black-Scholes option valuation model until settlement. Full value awards settled in cash will be valued based on the closing stock price at the end of each quarterly reporting period until the award settles in cash. As a result, cash-settled awards will be significantly less cost-effective under the new rules than vehicles settled only in stock.

Share-Based Compensation Cost: Equity Awards and Intrinsic Value

In those unique situations where publicly traded companies cannot estimate the fair value of an award at grant date, the ED mandates the share-based award be valued at the end of each quarterly reporting period using the intrinsic value method.

CORE INPUTS

Fair Value Model Input	Example
Underlying Stock's Fair Market Value	<i>An increase in the input will result in an increase to the award's fair value.</i>
Exercise Price	<i>The more a holder has to pay for the underlying share relative to the fair market value of the stock at the time of the grant, the lower the option value.</i>
Dividend Yield	<i>The greater the dividend, the lower the value of the underlying option because of the opportunity cost of foregone dividends.</i>
Risk-Free Rate	<i>Interests rates reflect the carrying cost of the underlying security — the higher the interest rate, the greater the benefit of having the option rather than the underlying security.</i>
Volatility	<i>Lower volatility implies less likelihood that the stock will appreciate far above the exercise price by the expiration date. Therefore, the higher the volatility, the higher the value of the underlying option.</i>
Option Term	<i>A shorter term provides less time for the option to appreciate. Therefore, as option term increases, value likewise increases.</i>



ATTRIBUTION

The ED requires U.S. publicly traded companies to allocate the compensation cost of share-based awards over the "requisite service period." The requisite service period can either be explicit, implicit or derived, defined below.

The number of shares/units expected to vest and the corresponding compensation cost is adjusted based on expected forfeitures over the service or performance period. Publicly traded companies are permitted to revise the initial amortized compensation cost if the share-based awards satisfy the service or performance conditions and to the extent that actual forfeitures differ from the predicted, a true-up must occur. However, for market conditions that affect either vesting or exercisability, any costs accrued for an award that is ultimately forfeited or cancelled without becoming vested cannot be reversed.

Recognition of Share-Based Compensation Cost

Companies are required to recognize share-based compensation costs over the requisite service period. Share-based awards with cliff vesting will be accrued on a straight-line basis over the requisite service or vesting period. Share-based awards with graded vesting will be required to apply the accelerated amortization method prescribed by the FASB Interpretation Number (FIN) 28. While this does not change the total cost of a share-based award, it shifts a much greater portion of the cost into the earlier years of the vesting period.

Figure One compares the accrual process under the straight-line and FIN 28 with a four-year annual vesting schedule.

Companies that have not yet voluntarily adopted the expensing treatment and plan to continue granting ratably vesting options leading up to the year of mandated expensing may have an opportunity to shift a greater portion of the costs into the SFAS 123 footnotes in early years and out of actual financials in later years by applying the FIN 28 method as soon as possible. Companies should consult with their auditors to determine the best method of applying this new amortization method.

Share-Based Modifications and Cancellations

The ED requires publicly traded companies to accrue an incremental compensation cost (difference between the fair value of the modified award and original award at modification date) for any modifications to the stock price, the term, settlement date, vesting schedule, transferability, share-based restructuring or equity exchanges in cases of corporate activity. In addition, the FASB classifies cancellations of share-based awards as a "modification" if the original holder simultaneously receives a new share-based award.

Figure Two illustrates the basics of accounting process for modifications of outstanding share-based awards.

Share-Based Compensation Tax Issues

In general terms, the ED states that a company's tax deduction on the income statement for share-based awards cannot be greater than the cost recognized. In the event a tax deduction is greater than the company's reported compensation cost, the ED requires the company to recognize the excess tax benefit in a credit to additional paid-in capital and the cash flows as financing cash

	<i>Definition: A service period that is ...</i>	<i>Example</i>
Explicit	<i>... directly stated in the terms of the share-based award arrangement.</i>	<i>Award cliff vests at the end of 3 years. Requisite Service Period: 3 years</i>
Implicit	<i>... not directly stated in the terms, but can be reasonably inferred from analysis of those terms and other performance conditions.</i>	<i>Award vests when new product is launched. New product expected to be completed in 18 months. Requisite Service Period: 18 months</i>
Derived	<i>... relevant only for awards with market conditions. Fair value models can be used to derive the assumed rates of return on company stock and from this, the time expected to meet that market condition.</i>	<i>Award vests when stock price doubles. A valuation model can be used to establish the modal time required to achieve the target based on the underlying assumptions. For example, 5 years is the expected period required to double the stock price. Requisite Service Period: 5 years</i>

inflows. In cases where the tax deduction is less than the company's reported compensation cost, the ED requires the company to recognize the difference in the income statement resulting in an increase to income tax expense.

ESPP PROGRAMS

As previously mentioned, any ESPP program providing a discount to employees that is not otherwise available to shareholders of the same class of shares will be considered compensatory and will incur an accounting charge. Common ESPP designs include a discount applied to the lower of the stock price at the beginning or end of a specified period, typically ranging from six to 24 months. Under the proposed accounting changes, both the discount offered and the lookback, or option, feature must be valued and accrued as a cost.

GOING FORWARD

Publicly traded companies should determine the impact stock option expensing will have on their actual financial statement using both the binomial and Black-Scholes valuation models. As companies estimate the expected compensation cost for granting stock options in the new environment, they should reevaluate their current equity granting strategy and determine if delivering options or some other form of share-based award vehicles will best achieve company objectives while, at the same time, minimizing the actual compensation cost. The more level accounting playing field offered by the expensing treatment provides an opportunity for companies to revisit their long-term incentive programs and choose the vehicles that best fit the company's strategic goals over the long term rather

Figure One

Assumptions: 1,000 shares granted • Fair value = \$10 • Four year, annual vesting of 25% per year

Under straight-line accrual, this is viewed as a single grant and accrued as follows:

Grant Value:	Percent Vesting In ...				=	Amount Accrued In ...				
	Year 1	Year 2	Year 3	Year 4		Year 1	Year 2	Year 3	Year 4	
\$10,000 x	25%	25%	25%	25%		\$2,500	\$2,500	\$2,500	\$2,500	
As a percent of original \$10,000 share grant value:						25%	25%	25%	25%	= 100%
Percent accrued in footnotes:						25%	NA	NA	NA	= 25%
Percent accrued in actual financials:						0%	25%	25%	25%	= 75%

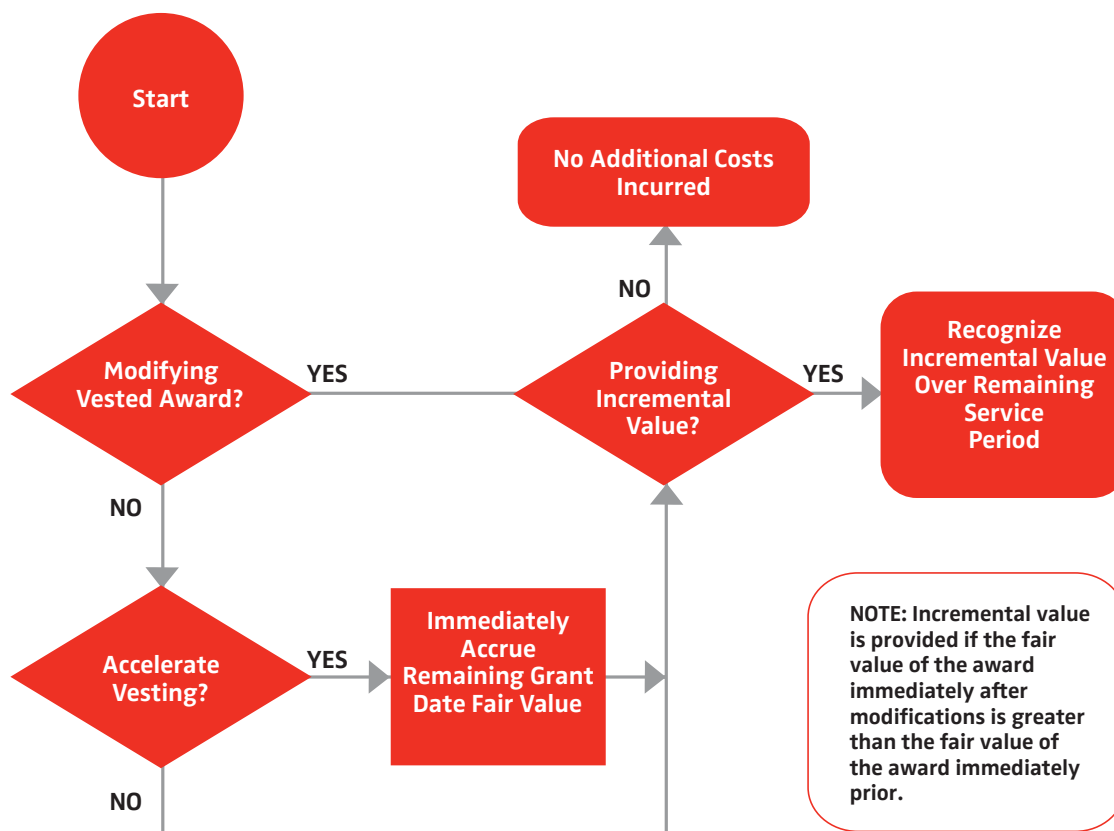
Under FIN 28, this would be viewed as four separate grants valued at \$2,500 each and accrued as follows:

Grant Value:	Percent Vesting In ...				=	Amount Accrued In ...				
	Year 1	Year 2	Year 3	Year 4		Year 1	Year 2	Year 3	Year 4	
\$2,500 x	100%					\$2,500				
\$2,500 x	50%	50%				\$1,250	\$1,250			
\$2,500 x	33%	33%	33%			\$833	\$833	\$833		
\$2,500 x	25%	25%	25%	25%		\$625	\$625	\$625	\$625	
TOTAL:						\$5,208	\$2,708	\$1,458	\$625	
As a percent of original \$10,000 share grant value:						52%	27%	15%	6%	= 100%
Percent accrued in footnotes:						52%	NA	NA	NA	= 52%
Percent accrued in actual financials:						0%	27%	15%	6%	= 48%

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If this is the year in which expensing is adopted, you only accrue 48% of the cost in the actual financials because 52% was already accrued in the SFAS 123 footnotes in Year 1.
 If you were straight-line accruing, you would have to accrue 75% in the actual financials as only 25% would have been accrued in the SFAS 123 footnotes in Year 1.

Figure Two



than choosing the vehicle that provides only the best accounting treatment. Many human resources and finance professionals will be searching for reliable information on what other companies are doing in response to this issue. Unfortunately, because of the fast evolving nature of these changes, sound market data on how others are responding will not be available for some time. Instead, human resources and finance professionals will have to look internally to make the decisions that are right for their own companies based on strategic objectives defined and cost/benefit analyses performed.

To help companies prepare for the proposed accounting rules, Buck recommends that human resources and finance professionals consider five key actions before the rules are mandated.

These are all important action items that need to be addressed before the new accounting rules take effect so that well thought out, strategic decisions can be made.

HOW CAN BUCK HELP?

Buck’s compensation consulting professionals have extensive experience in the evaluation and design of equity compensation. Buck has developed specialized equity design and planning tools: Equity StrategistSM and FLEX-LTISM to assist companies in reevaluating their equity delivery strategy.

With Buck as your advisor, our compensation consultants can combine your company’s equity grant history with more than 100 financial and company-specific assumptions to produce prospective earnings per share calculations. These calculations will prove invaluable in ensuring that your company’s compensation programs best match your philosophy and strategic business goals. In addition, Buck’s human resource solutions can assist you with marketplace insight and context, plan design or equity plan proxy vote issues.

KEY ACTION ITEMS

Calculate Compensation Cost for Current and Expected Future Awards

Determine the estimated compensation cost of granting stock options under the company's current valuation methodology.

Assess Binomial vs. Black-Scholes and the Underlying Assumptions

Examine current use of Black-Scholes as an option valuation approach to determine if an alternative approach, or changes to the assumptions, may offer a better result.

Adopt FIN 28

Seek auditor's approval to adopt the FIN 28 cost accrual method to front load option costs in the FAS 123 footnote for fiscal years beginning before June 15, 2004.

Examine ESPP

Model the projected costs of the ESPP program under its current design, as well as variations on look-back periods and discounts offered. The interplay of the ESPP with other rewards programs including short- and long-term incentive opportunities and retirement/savings programs must also be considered.

Reevaluate Equity Delivery Strategy

Assess if an alternative equity approach is more suitable in accomplishing strategic business objectives. Determine how equity participation rates and grant levels might need to change in anticipation of the new accounting rules.

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