

Buck's Option Expensing Update: FASB's Preliminary Decisions and Strategies for Cost Mitigation

Recent preliminary decisions made by the Financial Accounting Standards Board (FASB) as part of its Equity-Based Compensation (EBC) project have shed light on their intended direction in the ongoing option expensing debate. The FASB plans to issue an exposure draft of the new EBC accounting rules in the first quarter of 2004 and to mandate adoption by all publicly traded U.S. companies in the fiscal year beginning after December 15, 2004 (fiscal 2005 for calendar fiscal year companies, fiscal 2006 for non-calendar fiscal year companies).

The FASB's preliminary decisions provide those companies that have not yet voluntarily adopted the expensing treatment of SFAS 123 with a window of opportunity to implement EBC expense mitigation strategies. This paper summarizes some of the FASB's preliminary decisions and outlines certain tactical and strategic actions that companies can take to minimize impending accounting costs.

In March 2003, the FASB initiated its EBC project to re-examine accounting issues relating to stock compensation. The project's objectives were to determine whether and how certain EBC arrangements should be recognized in financial statements and to facilitate the convergence of U.S. rules with those of the International Accounting Standards Board (IASB).

As of this writing (mid-January 2004), the FASB has met 18 times to discuss the EBC project. At each session, the Board addressed certain issues and made preliminary decisions to be included in the new exposure draft. The table on page 2 summarizes, in Question & Answer format, some of the preliminary decisions related to the FASB's intended direction.

FASB UPDATE

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COST MITIGATION STRATEGIES

As of this writing, more than 360 companies have voluntarily adopted the current SFAS 123 expensing treatment. The majority of companies continue to account for EBC under APB 25 (resulting in zero expense for traditional at-the-money stock options), electing instead to take a wait-and-see approach to the FASB developments.

This wait-and-see approach now provides a unique opportunity to capitalize on strategies to mitigate the costs associated with the transition from cost-free accounting to expensing. The following discussion details cost saving actions, which can be separated into two primary categories:

- **Tactical actions** — immediately actionable techniques for mitigating the impact of EBC awards that are already granted and outstanding just prior to the effective date of the new expensing rules
- **Strategic actions** — long-term refinement of EBC philosophy and practices to maximize cost efficiencies after the mandatory implementation of the new expensing rules

It is important to note that any action taken with respect to an organization's EBC practices may create a reaction in the investment community — be it positive or negative. The investor relations function should work closely with human resources and finance departments as they consider each of these actions.

Tactical Actions

1. Avoid Early Voluntary Adoption of SFAS 123

The FASB no longer provides beneficial transition rules for companies that voluntarily adopt SFAS 123 before the proposed mandatory effective date. Based on previous FASB pronouncements (SFAS 148, issued in December 2002), it appeared that early adopters would be rewarded with the preferable prospective-only transition. This

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To whom will the new accounting rules apply?

The new FASB rules will apply to all publicly traded U.S. companies. (IASB rules, which are expected to be substantially similar if not identical to the FASB's, will govern European Union companies.) The FASB indicated that non-public U.S. companies will be given a choice between fixed fair-value and variable intrinsic value accounting.

What is the effective date?

The new rules will be effective for fiscal years beginning after December 15, 2004. For calendar fiscal year companies, that will be fiscal year 2005. For non-calendar fiscal year companies, that will be fiscal year 2006.

Are companies permitted to voluntarily adopt SFAS 123 (the current expensing treatment) at an earlier date?

Yes. Early adoption of the fair value accounting method for equity-based compensation is permitted.

How must companies transition to the new accounting treatment?

Transition to the fair value accounting method will take place under the modified prospective method. In short, accounting costs will need to be recognized as follows:

1. Prospectively for all EBC awards granted or modified beginning in the first fiscal year after December 15, 2004; and
2. Retrospectively for all unvested EBC awards granted or modified in fiscal years starting after December 15, 1994.

Are there separate transition rules for early SFAS 123 adopters?

No. No other transition rules are offered to companies that voluntarily adopted SFAS 123 prior to the effective date.

How will the compensation cost be measured?

EBC award costs will be measured at the date of grant using a fair-value model. In the case of stock options, it appears that the FASB will allow companies to select a particular model (e.g., Black-Scholes, binomial), but will provide greater guidance in determining the required model inputs than is outlined in the current SFAS 123.

How will the compensation cost be accrued in the income statement?

EBC awards with cliff vesting will be accrued on a straight-line basis over the vesting period. EBC awards with graded vesting will be required to apply the accelerated amortization method prescribed by FASB Interpretation Number (FIN) 28. While this does not change the total cost of an EBC award, it shifts a much greater portion of the cost into the earlier years of the vesting period. The FIN 28 method is described in greater detail later in this paper.

approach would have allowed these companies to avoid the costs associated with EBC awards granted prior to the year of adoption. However, this incentive has been taken off the table with the FASB's recent decision requiring all companies to retroactively apply the treatment after the effective date of the new expensing rules (under the so-called modified prospective rule discussed previously).

It is not clear what rules the final statement resulting from the release of the exposure draft and receipt of public comment will contain. When the FASB originally issued SFAS 123 in 1994, there was a strong backlash from the business community and Congress. These objections resulted in the FASB allowing companies to continue applying APB 25 and provide the SFAS 123 costs only in financial footnotes. While it seems that the recent corporate governance reform movements are providing greater support for the expensing treatment, strong dissension still exists in certain industries, particularly high-technology and other growth sectors. Additionally, two bills have been introduced in Congress that would impose a moratorium on EBC accounting changes. Because the adoption of the expensing treatment is an irrevocable decision, doing so at this time may be premature when the future of this issue isn't known.

2. Apply the FIN 28 Front-Loaded Accrual Treatment Immediately

FASB Interpretation Number (FIN) 28 originally prescribed the method of accruing costs associated with stock appreciation rights and performance-based EBC awards accounted for under APB 25. The current SFAS 123 requires its use in certain circumstances. And, as discussed previously, the FASB intends to require the FIN 28 method for all ratably-vested EBC awards under the new expensing rules (note that ratably vested refers to any EBC award that vests in tranches, i.e., gradually, as opposed to a cliff vest).

FIN 28 doesn't change the total costs associated with an EBC award, but requires the costs to be accrued in the income statement on a front-loaded basis. Traditionally, companies have accrued the cost on a straight-line basis (an EBC award with a four-year vest schedule would accrue 25 percent of the cost per year). Under FIN 28, a greater percentage of the cost would be accrued up front, with a lower percentage accrued in later years. Figure One illustrates the difference between straight-line and FIN 28 accrual for an EBC award with a four-year vesting schedule.

Because companies taking the wait-and-see approach to the expensing treatment will continue to disclose EBC costs only in the SFAS 123 footnote in 2004 (and 2005 for non-calendar fiscal year companies), they find themselves with the unique opportunity to shift the cost into one or more years of footnote disclosure and out of years of actual recognition as an income statement expense.

Applying the FIN 28 method, as already mentioned, doesn't change the total cost of the EBC award, but shifts the cost to earlier reporting periods. And as the FASB has already indicated that the treatment will be required in the new rules, it benefits companies to try to apply it as early as possible while these costs still only appear in financial footnotes.

3. Manage Costs of Severely Underwater Options

For those companies with outstanding underwater options, the mandatory imposition of retrospective option expensing can be particularly painful. Not only do the unvested portions of past option grants need to be accrued, but this cost is for options that may have no perceived value to the employee because they are out of the money.

These companies may want to consider accelerating the vesting on any significantly underwater options before the effective date of the new expensing rules. Doing so would move the associated costs into the SFAS 123 footnote before they need to be recognized in the actual financials. Under APB 25, accelerating the vesting of an outstanding, underwater award results in no compensation charge in the actual income statement (only the SFAS 123 footnote). In addition, modification of vesting is not an action that requires shareholder approval under the new NYSE corporate governance rules (according to the December 16, 2003 NYSE release entitled: FAQs Regarding Rules Governing Stockholder Approval for Equity Compensation Plans).

That said, companies considering this strategy must be sensitive to how it will be perceived by shareholders. A case can be made that this is an appropriate strategy for significantly underwater options that do not stand a chance of coming into-the-money before their remaining vesting runs out. However, if the potential that these options can come into-the-money sooner remains, accelerating their vesting removes any retentive value they may have provided.

Those companies seeking shareholder approval in 2004 to execute a six-month-and-a-day (6+1) underwater stock option exchange should consider additional implications. The 6+1 program was devised to avoid accounting charges associated with traditional repricings under APB 25. Under the expensing treatment, on the other hand, underwater option exchanges can be executed without subjecting the employee to a risky six-month waiting period. Additionally, if the immediate exchange of underwater options is performed on a value-for-value basis (i.e., more underwater options are surrendered than are regranted at a new price), no additional compensation expense will result from the transaction. With this in mind, it may be beneficial to wait until after the effective date of the FASB's new expensing rules before executing the underwater exchange. Of course, if the program is meant to address critical employee retention issues, postponement may not be possible.

4. Grant Stock Options With Non-Traditional Vesting Schedules

Companies granting stock options in 2004 can apply non-traditional vesting schedules to further shift accounting costs into earlier periods during which only footnote reporting is required. Companies may want to consider granting options that vest substantially before the effective date of the new expensing rules, with the remaining unvested options vesting ratably over a longer period of time thereafter.

This is again a strategy that may be perceived negatively by shareholders if the explanation for its use cannot be defended effectively. If an organization considering this strategy is sensitive to shareholder perception, it may want to use it only with premium-priced stock options. Premium-priced options do not generate an income statement cost under APB 25 and are more favorably viewed by shareholders. Additionally, a premium price provides an effective extension of vesting under the assumption it will take more time for the option to gain value.

Figure 1

Assumptions: 1,000 shares granted • 4 year, annual vesting of 25% per year

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

Grant:	Percent Vesting In ...				=	Amount Accrued In ...			
	Year 1	Year 2	Year 3	Year 4		Year 1	Year 2	Year 3	Year 4
1,000 x	25%	25%	25%	25%		250	250	250	250

Under FIN 28, this would be viewed as 4 separate grants of 250 shares a piece and accrued as follows:

Grants:	Percent Vesting In ...				=	Amount Accrued In ...			
	Year 1	Year 2	Year 3	Year 4		Year 1	Year 2	Year 3	Year 4
250 x	100%					250			
250 x	50%	50%				125	125		
250 x	33%	33%	33%			83	83	83	
250 x	25%	25%	25%	25%		63	63	63	63
TOTAL*						521	271	146	63
As a Percent of original 1,000 share grant:						52%	27%	15%	6%

↑

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'd have to accrue 75% in actual financials as only 25% would have been accrued in the SFAS 123 footnotes in Year 1.

*Share figures do not sum to 1,000 due to rounding.

STRATEGIC ACTIONS

1. Reevaluate EBC Eligibility and Participation at Each Organizational Level

When moving from a situation where traditional stock options (the form of EBC most widely used historically) go from being cost-free to creating an expense on the income statement, many organizations currently granting them deep into their organizations will ask themselves whether certain employee groups should remain eligible in the future, or continue to participate to the extent they once did.

In a recent flash survey, Buck's compensation consulting practice asked participants whether the mandatory imposition of the expensing treatment will make certain employees ineligible for future grants. We found that, while very few companies would eliminate managers and above, 20 to 33 percent of the surveyed companies would eliminate long-term incentive eligibility below the manager level. [Figure Two]

For those surveyed companies that would not eliminate eligibility entirely, annual participation in long-term incentive programs promises to decrease more dramatically at the lower levels as well. [Figure Three]

2. Research Available EBC Valuation Models and Assumptions

Another cost mitigation strategy is to evaluate different stock option valuation models available within the guidelines of the new expensing rules. Over the next few months we are sure to see alternative models emerge, such as binomial (or lattice-based) models and other variations. While stock option valuations will not vary radically between models, some may be better suited than others to incorporate company-specific practices such as vesting, non-transferability and historic employee exercise experience. Each model should be evaluated to find the approach that best fits each organization's approach to delivering stock compensation.

Additionally, companies should evaluate how they determine the inputs to these valuation models — in particular, assumptions about their stock's expected volatility and expected period of time options will be held before exercise. In light of changing market conditions, the valuation assumptions currently being used for SFAS 123 footnote reporting purposes may not accurately reflect the expected stock price movement or stock option life on a

go-forward basis. In cases where the expected volatility and holding term assumptions can be adjusted downward, companies may experience reduced accounting costs.

3. Examine Alternative EBC Vehicles

Stock options are the primary form of EBC vehicle in use today due in very large part to their preferential cost-free accounting treatment. However, the new expensing rules will provide a more level playing field on which to select the EBC vehicles that best meet company objectives. In preparation for the new rules, every company should compare their long-term business objectives with the advantages and disadvantages each EBC vehicle offers relative to the achievement of those goals.

In its recent survey on the topic, Buck found that while stock options have delivered over 95 percent of total long-term incentive value historically, the mix will change considerably once expensing is mandated. [Figure Four]

There is no one mix of long-term incentive vehicles that will be right for every organization. For any given company, some vehicles may be more cost-efficient than others. More mature organizations, for example, may be able to deliver equal compensation value for lower accounting costs by using restricted stock rather than stock options. Performance options and performance shares may also be more cost efficient if they are only delivered (and cost recognized) when and if certain performance goals are met.

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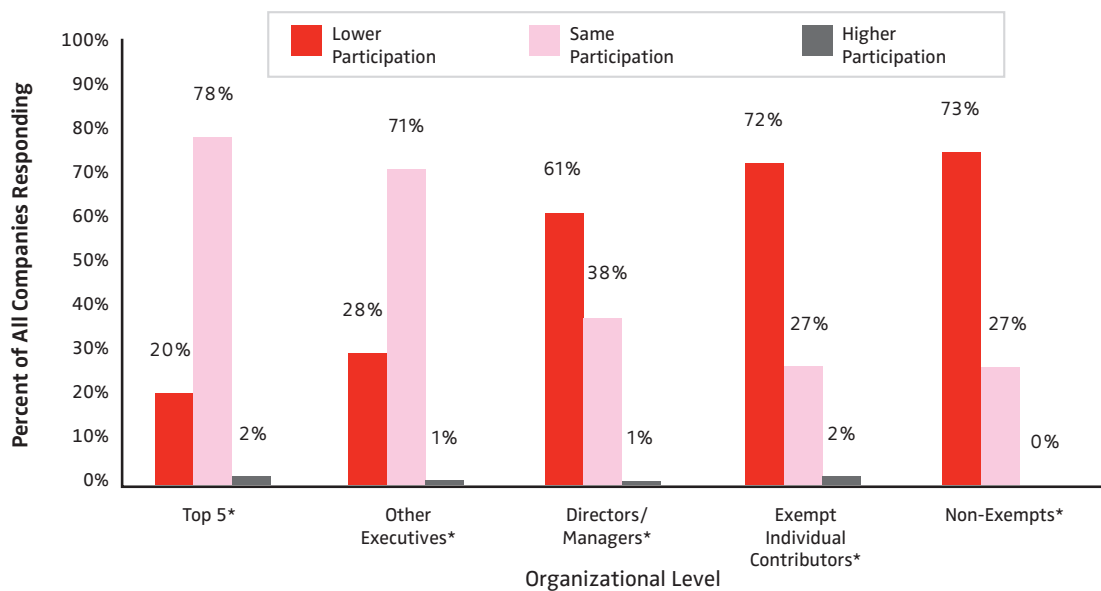
Figure 2

Percent of Companies that Would Eliminate Long-Term Incentive Eligibility in Response to Mandatory Expensing



Figure 3

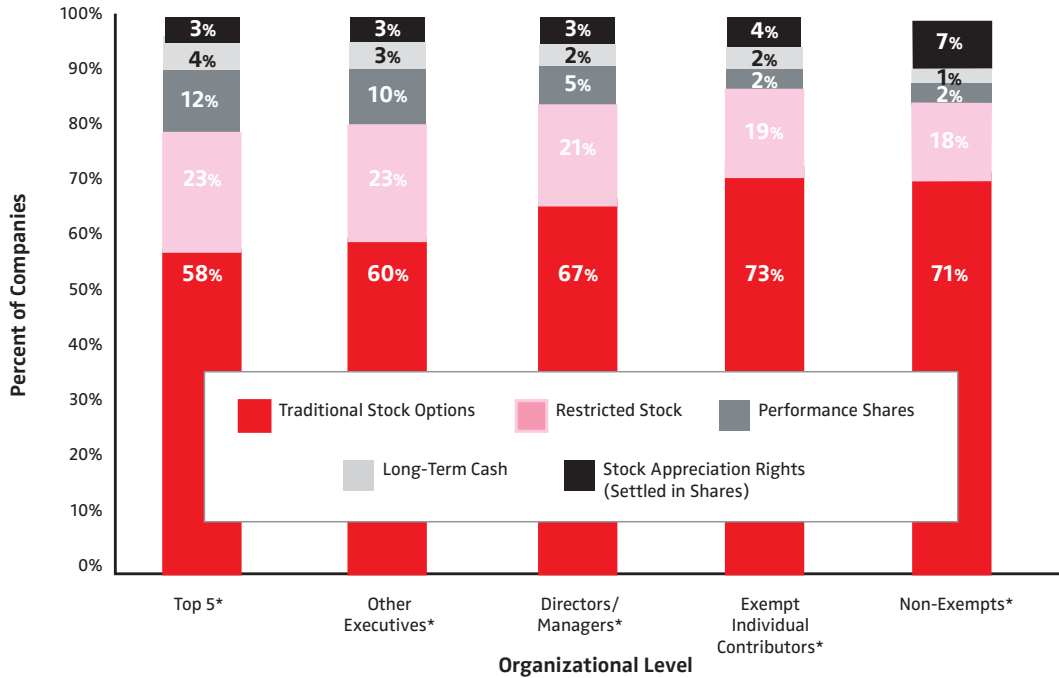
Changes in Surveyed Companies to Long-Term Incentive Annual Participation in Response to Mandatory Expensing



*Due to rounding, numbers don't always add to 100%.

Figure 4

Projected Mix of Long-Term Vehicles After Mandatory Imposition of SFAS 123 for All U. S. Companies



*Due to rounding, numbers don't always add to 100%.

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