FASB Finalizes Statement on Stock Option and ESPP Expensing

As described in our May 2004 Client Alert entitled “FASB Issues Proposal on Stock Option and ESPP Expensing,” stock option expensing is on its way. Not only will this affect stock option and other equity award practices, but most employee stock purchase plans, or ESPPs, that contain a discount or a so-called look-back feature (e.g., a purchase price equal to 85% of the lower of the starting or ending stock price) will also be affected. It is important that companies that grant stock options or other equity awards, and companies that have ESPPs, consider the implications of the recently finalized accounting rules before they become effective.

Background

The Financial Accounting Standards Board (“FASB”) recently issued the final statement (“FAS 123R”) on share-based payments that addresses the issue of expensing stock options and other equity awards to a company’s employees and directors. FAS 123R is an amendment to FASB Statement No. 123 and supersedes APB Opinion No. 25 (“APB 25”). FAS 123R is applicable to any award that is settled or measured in stock, including, for example, stock options, restricted stock, stock appreciation rights, stock units, and ESPPs.

Effective Dates

FAS 123R will be effective for public companies starting with the first interim period commencing after June 15, 2005 (i.e., July 1, 2005 for calendar year companies, and therefore reportable in the third quarter Form 10-Q), and for private companies starting with the first interim period commencing after December 15, 2005. Once a company is subject to FAS 123R, all stock options or other equity-based awards to employees or directors that vest or become exercisable after the effective date must be accounted for under FAS 123R. For example, if a calendar year public company granted an option to an employee on December 1, 2003 that becomes exercisable in two equal annual installments, then the second half of the award (i.e., the half that becomes exercisable on December 1, 2005) will have an expense associated with it.

Stock Options and Other Equity Awards

FAS 123R will require companies to measure the “fair” value (as opposed to the intrinsic value (i.e., the “spread”) under APB 25) of options and other equity awards at the time of grant using a valuation method such as Black-Scholes or a binomial model, and then expense the value of the award as follows:
For options and other awards that are settled in stock (including such awards that have performance-based vesting), the fixed fair value of the award is generally accrued over the vesting period. In this regard, since both stock appreciation rights settled in stock and awards with performance-based vesting (e.g., vesting tied to revenue or EBITDA) will no longer be subject to variable accounting treatment, we anticipate that the use of such grants may increase, as these awards will be subject to the same treatment as traditional options with time-based vesting.¹

For awards that are settled in cash (e.g., a cash stock appreciation right), the fair value of the award will be re-measured each quarter (i.e., it will be subject to variable accounting treatment).

If any award is later modified, then the incremental value will be re-measured at the date of modification and any incremental value will need to be accrued over the remaining vesting period. Generally, any awards (whether subject to fixed or variable accounting treatment) that do not vest will not be expensed. In most cases, the expenses accrued for unvested awards that expire or are forfeited can be reversed. However, if the vesting of an award is contingent on a market-based measure (e.g., stock price), then the expense cannot be reversed. In addition, once an award vests, the expense cannot be reversed even if the award subsequently expires unexercised. Private companies may elect to continue to use the intrinsic value method of determining the option expense (i.e., the “spread”). Private companies that elect this approach, however, will need to re-measure the intrinsic value on a quarterly basis. In other words, private companies can measure the expense based on the award’s spread, but will be subject to variable accounting treatment.

**Employee Stock Purchase Plans (ESPPs)**

Most notably, FAS 123R will generally require expensing of employee stock purchase plans, or ESPPs. The typical ESPP permits participants to purchase company stock at a discount, generally 15%, such that the purchase price is 85% of the lower of the stock price either at the end of the purchase period or at the beginning of the so-called “look-back” period (typically six months). FAS 123R will require companies to take an expense equal to the sum of any discount (unless the discount is 5% or less, in which case there is no expense) and the fair value of any look-back (if the ESPP contains a look-back provision). If the ESPP does not have a “look-back” provision, has a discount of 5% or less and meets certain other requirements regarding participation and enrollment, it is considered a noncompensatory plan under FAS 123R and compensation costs will not be recognized (i.e., there will be no expense).

¹ Due to the recently enacted Section 409A of the Internal Revenue Code regarding non-qualified deferred compensation, the use of any SARs by private companies or cash-settled SARs by publicly-traded companies is greatly restricted. See our October 2004 and December 2004 Client Alerts on this topic.
Actions to Consider

We recommend that our clients consider the following before FAS 123R becomes effective:

- For companies with ESPPs, consider whether to eliminate any look-back provision and/or reduce any discount to 5% or less, or whether to discontinue such plan entirely.
- Consider shortening the terms of options to reduce the fair value of the options.
- Consider the use of other stock-based awards, such as restricted stock or restricted stock units, since the bias in favor of stock options has been eliminated. Restricted stock and restricted stock units are less dilutive of shareholders and can deliver value even in a down market.
- Discuss with your accountant or consultant the merit of Black-Scholes versus a binomial valuation model.
- After FAS 123R becomes effective, consider performance-based vesting in lieu of time-based vesting since variable accounting will no longer apply to such awards.

For further information on this topic, please contact:

Marian A. Tse  mtse@goodwinprocter.com  617.570.1169
Scott A. Webster  swebster@goodwinprocter.com  617.570.8229
Lynda T. Galligan  lgalligan@goodwinprocter.com  617.570.1090