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Executive Compensation and Benefits

FASB Publishes Exposure Draft on Changes to Accounting Rules for Equity Compensation

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On March 31, 2004, the Financial Accounting Standards Board ("FASB") published for public comment a draft Statement proposing amendments to FASB Statement Nos. 123 ("FAS 123") and 95. The public comment period ends on June 30, 2004.

The draft Statement is over 200 pages, but the following points immediately stand out:

Effective Date

- The Statement takes effect and must be applied for fiscal years beginning after December 15, 2004. On that date, a "fair-value" method must be used by (i) all public companies and (ii) those private companies that currently use a "fair-value" method under FAS 123. The Statement prospectively applies to new awards and to prior awards granted after December 15, 1994 that are unvested as of the date the Statement becomes final.

- For private companies (excluding those already using one of the "fair-value" methods of FAS 123) the requirements of the draft Statement do not take effect until the first fiscal year beginning after December 15, 2005, at which time private companies may elect to measure the expense of their equity-based awards by using either an "intrinsic value" method (such as the current method in use under APB Opinion No. 25), or a "fair-value" method. However, a private company that elects to use the "intrinsic value" method must recognize the value of the award ("mark to market") throughout the term of the award. Private companies are not required to apply the draft Statement to awards that were in existence prior to the first fiscal year beginning after December 15, 2005.

Application of the Statement

- The draft Statement requires companies to estimate, as of the grant date, the fair value of an award an employee will receive if the requisite service periods or performance objectives are satisfied.

- In determining the "fair value" of an award, service periods and performance objectives (*i.e.*, vesting requirements) are not taken into account, but conditions imposed on transferability or exercisability (*i.e.*, market conditions) are taken into account.

- Two "fair-value" methods are specifically permitted:

  - "Lattice" method (a binomial, or other, model that attempts to take into account, in arriving at a value, a greater range of possible outcomes). The lattice method relies on the use of subjective, self-referential variables for each issuer (such as the issuer's experience with the number of shares actually issued under awards and the dates on which shares will be issued). This is the preferred method. Some of the factors required for a lattice method, as applied to a stock option that vests in installments over time, are: the expected term of the award, the expected volatility in the price of the underlying security, and the expected exercise-behavior of holders (this latter requirement permits issuers to differentiate awards held by executives and non-executives when their exercise-behavior differs). The draft Statement provides illustrations of the application of a lattice method to a stock option with a variable exercise price or subject to a market condition.

  - "Closed-end" method (essentially the Black-Sholes option valuation model). Because a valuation using a lattice method is preferred over a closed-end method, once a lattice method is adopted, a company generally is not permitted to return to a closed-end method.

- The estimate of the actual number of shares that will vest should be based on each issuer's own experience with their equity awards and their assessment of how future behavior and events will track past history. Vesting experience may be adjusted over the term of the award and any forfeitures would be reflected for the reporting period in which the adjustment takes place. This estimate requirement will require more detailed recordkeeping and more sophisticated techniques to convert such records into useable data.

- Awards that are settled in shares would be classified as "equity awards" whereas awards that can be settled in cash would be classified as "liability awards". Awards classified as "liability awards" are to be revalued each financial-reporting period. Ongoing revaluation will not generally be required of awards classified as equity. However, both types of awards require that the associated expense be recognized in stages on each financial reporting date that occurs during the period for earning the award (generally meaning the vesting period). Stock options or restricted stock awards that permit exercise through broker-mediated cashless exercise programs, or that permit "net withholding" for tax purposes, would be classified as "equity awards".

- Modification of equity awards, including repricing, would result in a measurement of additional or decreased expense based on the additional or decreased value created by the modification. This additional or decreased expense, in the case of unvested shares, would be spread out over the remaining vesting period.

- Equity awards to non-employee directors of the issuer continue to receive the treatment accorded equity awards to employees. However, only awards issued to directors for service as a director would receive this benefit. This is arguably consistent with the application of existing rules under APB 25, although existing rules have sometimes permitted large awards received for service as an employee to continue to receive APB 25 accounting after termination of employee status while the person remains a director.

- Employee stock purchase plans (ESPPs) would be subject to the draft Statement except where ESPP shares are sold on terms no more favorable than those made available to all stockholders of that class of shares. Thus, a compensation charge will likely be imposed with respect to ESPPs that continue the current, tax-favored, practice of providing a purchase price discounted 15% from fair market value and/or have a "look-back" feature. The compensation charge would reflect the 15% discount and/or the "look-back" feature. Therefore, the use of ESPPs as an employee-retention tool may be discontinued by a company if the associated compensation expense to the company is deemed to outweigh the competitive advantage gained.

The FASB is almost certain to adopt the draft Statement (with some modification). Therefore, we expect our issuer-clients to evaluate the compensation expense associated with other types of awards (for example, stock appreciation rights and restricted shares) against the expense associated with stock options (and within stock options to examine the expense associated with time-based versus performance-based vesting) in determining how best to align the interests of award-recipients with those of the issuer's shareholders.

We will follow up this memorandum with a more specific discussion of the final rules when the FASB adopts them. Please contact Scott Spector at (650) 335-7251, sspector@fenwick.com with your questions or comments.

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