COMPLIANCE WEEK
The leading resource on corporate compliance and governance for U.S. public companies.

The Coming Storm: Mandatory Expensing of Stock Options

By Harvey L. Pitt, Compliance Week Columnist—December 16, 2003

In 1995, FASB required corporations either to expense stock options at the time of grant, reflecting their estimated fair value directly in their income statements, or to disclose the pro forma impact of expensing options in a financial statement footnote.

Typical stock option plans that establish the number of shares and exercise price at the time of grant could be valued in a company's financial statements at their "intrinsic value" — the difference between the option exercise price and the stock price on the grant date.

Because these options typically were granted at a price equal to the stock price on the grant date, no compensation expense needed to be recognized in a company's income statement. Companies choosing footnote disclosure were mandated to use "fair value" accounting — the use of an option-pricing model to value the options as of the date of grant. Compensation cost is recognized over the service period (usually the vesting period)

Looking Towards 2005

But, the parade of numerous corporate accounting implosions, combined with the IASB's decision to require expensing for the rest of the world's companies, has rekindled debate on this thorny subject.

Now FASB has voted to require at least mature public company stock options to be expensed, probably starting with 2005 financial statements, at their fair value, using the "modified prospective" method. Under this valuation, the "fair value" method of expensing options is applied to options granted in the year of adoption and subsequently, as well as to all unvested options granted in previous years.

This has caused intense scrutiny of the issue, including consideration of legislation to preclude FASB's promised action. While no one can predict the precise outcome of these deliberations, public company Boards and management should review their stock option grant policies and procedures.

What To Review

Some items worthy of attention are:

1. **Using or Abandoning Options**

One issue is the future role, if any, stock options should play in corporate compensation.

Many companies already have begun reexamining the use of options as a compensation tool, and increasingly are turning to restricted stock awards instead.

But, that may not be optimal policy for all companies.

When properly crafted and focused, options can be a useful compensation tool. For example, they effectively and rapidly can increase stock ownership, which is useful for attracting new talent and incentivizing younger managers.

Changing policy on the use of options requires boards to articulate reasons for the change, and to conclude that abandoning them is in the best interests of the company and its shareholders.

Careful attention should be paid to prior articulated justifications for existing option grants to make sure the rationale for any change is fairly disclosed.

2. **Using Performance-Based Options**

As noted, current accounting rules permit valuing typical stock options at their "intrinsic value," which generally results in no compensation expense being recognized in a company's income statement.

In contrast, this favorable accounting treatment does not apply to "variable" performance-based stock option plans, where the number of shares and the exercise price may change. As a company's stock price increases under a variable plan, increasing amounts of compensation expense must generally be recognized each accounting period until the fixed number of shares and exercise price are known.

Since there's no way to determine in advance how much compensation cost must be recorded, companies have been reluctant to grant performance-based options.

Under the accounting rules FASB is expected to adopt, this disparity will no longer be an issue because the fair value of options will be determined at the date of grant for both fixed and variable options.

Directors and officers should begin acquainting themselves with the various types of performance-based option plans that may become prevalent beginning in 2005 when new FASB rules are expected to become effective. These include:

- Performance-based options exercisable only if a company meets performance targets set by the board and management based on the company's strategic objectives;
- "Indexed options" exercisable only if the company's stock outperforms the market or a peer group;
- Options with variable strike prices designed to assure shareholders of a minimum return equal to the risk-free rate before executives begin to be rewarded;

- "Performance vesting" options exercisable only if the company's stock price reaches certain targets, at which point the options vest;
- "Premium-priced" options (that is, "out of the money" options) exercisable once the strike price, which is set higher than the company's stock price on the date of grant, is reached. Premium-priced options can assure shareholders a minimum return before rewarding executives, without having to increase the option's strike price every year.

3. **Developing an Option Pricing Model**

   FASB has not designated any particular option pricing model for option grants.

   While companies are safest using well-established pricing methodologies, consideration should be given to other existing methodologies, or even the development of new methodologies that are rational, logical and easy to justify.

4. **Tax Treatment**

   Current tax law results in a deduction for employers, and taxable income for employees, for the amount options are "in the money" in the year exercised.

   Management of public corporations should urge Congress and the Administration to change the tax code so that both the amount of option expense deductible by corporations and the timing of such deductions conform to new FASB rules.

   However, the tax code should remain unchanged with respect to when and how employees are taxed on options. This makes sense because it is not until exercise that employees will be able to raise the cash needed to pay the tax.

Get Ready

In the current environment, companies have many different issues to keep them busy. But the likely change in accounting for stock option grants is something that affects every company's bottom line, and not solely because these options will have to be expensed.

Attracting and retaining qualified managers, figuring out an appropriate compensation policy and strategy, and ensuring transparency in corporate disclosures are all directly affected by this coming change.

It behooves companies to be prepared in advance.
