

COMPLIANCE WEEK

A Reaction To The Exposure Draft

By Daniel Abrams — April 6, 2004

In releasing the exposure draft, *Share-Based Payment, an amendment of FASB Statements No. 123 and 95*, the Financial Accounting Standards Board is formally proposing a requirement for all public companies to expense employee stock options in the year they are granted.

The compensation expense would be reported on the income statement using the "fair-value-based method" as measured by an option valuation model.

The Changes

FASB stated that it wants to maximize convergence of U.S. and international accounting standards for employee stock options, and the proposed statement is consistent with the standard of the International Accounting Standards Board's *Share-based Payment*, in advancing a mandate for all public companies to use the fair-value-based method.

Statement 123, issued in 1995, encourages companies to use the fair-value-based approach, but it allows the intrinsic value method alternative of APB Opinion No. 25, and requires only off-book footnote disclosure of the pro forma effects of the fair-value-based method. The proposed Statement requires non-public companies to use the intrinsic value method. In this case, the intrinsic value is reported, not only at the grant date, but also in each subsequent reporting period during the option's term.

The proposed Statement will be effective for new awards, or portions of existing awards that have not yet vested, at the beginning of the first fiscal year subsequent to Dec. 15, 2004. In anticipation of the new standard, many companies are voluntarily expensing, or at least reconsidering the mix of stock options and other equity-based and cash-based awards in their compensation packages.

Key Issues Of Concern

Notwithstanding the validity of FASB's principled position that pro forma disclosures are not an appropriate substitute for on-book recognition, the accounting change, per se, ought to have less of an economic impact than the redesign of compensation packages resulting from the accounting change. However, the proposed Statement raises at least three core issues that are cause for concern:

- i. The proposed Statement gives companies very general guidance on the implementation of the fair-value-based method, but leaves important questions unanswered about the details of implementation;
- ii. Grant-date accounting does not incorporate the true nature of employee stock options, which represent contingent claims on a company's own stock, and thus, convey additional market risk to shareholders;

ABOUT THE AUTHOR



Daniel Abrams is a senior consultant with NERA Economic Consulting, the global advisory firm that is part of \$11.6 billion

Marsh & McLennan.

A financial economist with a concentration in the areas of valuation and risk management, Abrams has valued private companies, business units and divisions of public companies, companies in distress, and illiquid assets and liabilities that are marketable and non-marketable. He has also provided guidance to companies and investors in the areas of mergers and acquisitions, money management, corporate financing, capital budgeting and project valuation, liquidation, contract design and litigation.

Abrams has also worked companies to analyze their core and non-core risks and to assess the potential economic and financial accounting implications of these exposures.

Prior to joining NERA, Abrams was a senior economist for the Law & Economics Consulting Group where he managed two of the largest litigation cases in the insurance and financial sectors, and developed financial valuation tools for a variety of clients.

He has also worked as a performance and measurement consultant for IBM, and was on the

- iii. U.S. standards do not converge with those of IASB in certain areas.

The main challenge in implementing the fair-value-based method is that stock options are not marketable by the employee. The traditional option valuation models are predicated on the existence of an active market in which options can be bought, sold or hedged. However, employees cannot generally buy, sell or hedge their options, so fair-value is not readily discoverable.

In addition to stock price and other objective factors, the value to the employee depends on subjective or personal factors that become significant in the absence of marketability. This, in turn, affects the amount and timing of cash flows from the company to employees as a result of option exercise, and therefore the estimated cost to shareholders. From the perspective of shareholders, the cost of option-based compensation can be measured reliably only to the extent that the aggregate behavior of employees is accurately incorporated in forming expectations of the value of cash flows from option exercise.

FASB's Option Valuation Group concluded that Black-Scholes, with expected term as an input (in accordance with FAS 123), is inadequate for implementing the fair-value-based method.

In keeping with NERA's recommendations, FASB is proposing that, contingent on the availability of sufficient information, companies use lattice models to value options.

IASB has not issued a similar recommendation to date.

In paragraph B20 of the proposed Statement, an example is given where an "entity's experience might indicate" that option holders tend to exercise when the stock price is twice the exercise price. All paths in the lattice on which the stock price reaches twice the exercise price will terminate at that point, assuming the option is vested. Consequently, expected term is an output of the model rather than an input.

In general, lattice models admit flexible parameter inputs that allow for varying subjective factors in different scenarios, as well as varying objective factors such as volatilities, dividend yields, and risk-free rates over different periods of the option's term. The example in paragraph B20 recognizes that the propensity of option holders to exercise early depends on stock price performance.

Reporting Problems & Core Issues

Black-Scholes admits only one number for expected term, which is an attempt to consolidate a complex profile of employee behavior. However, the proposed Statement affirms that a company may still choose Black-Scholes, if it does not have sufficient information or resources to use a lattice model.

This creates a financial reporting problem in 2005. How does a company establish whether or not it has sufficient information and resources to use a lattice model? If it does not have sufficient information, then should it make efforts and incur expenses toward acquiring sufficient information, rather than default to Black-Scholes? And where can companies acquire the information?

Very few companies can claim to have compiled comprehensive data on employee option-related behavior in different scenarios. Typically, a company's own historical experience, that is, what an "entity's experience might indicate" is not sufficient for reliable parameter estimation and might produce results that are not consistent from one time period to another, let alone one company to another. Additionally, many companies do not have the resources in-house to perform complex valuations that are consistent with objective standards and will pass the test of an audit.

In the face of these challenges, shareholders need to know whether Black-Scholes typically overstates, understates, or gives roughly the same answer vis-à-vis a more sophisticated flexible model. As a first step, a company should begin to research alternative valuation models that are likely to gain acceptance by auditors; not surprisingly, there are models promising deep valuation discounts that will not ultimately stand up to a careful audit. The phase I effort should involve a comparison of the valid models using varying assumptions centered on the company's own data. The ingredients for a more comprehensive solution reside, not only within the company, but with companies broadly for

team that developed the first collateralized mortgage obligation information service at Trepp & Company.

Abrams has lectured at the Cornell University Mathematics Department, and has written and spoken extensively on the issue of employee stock options. He is currently writing the AFP's *Guide to Valuation of Employee Stock Options for the Association for Finance Professionals*.

He can be reached [via email](#) or at (212) 345-7336.

which option-based compensation cost is significant, as well as the banks that process options transactions.

The first core issue can now be focused and rephrased. Companies should seriously consider the alternatives to Black-Scholes that FASB is proposing. However, they need specific guidance on the standard data sources and uses, as well as the costs and benefits of implementation.

The second core issue is grant-date expensing. The proposed Statement reaffirms the FAS 123 (and IFRS 2) methods of recognizing an expense based on option valuation at the grant date, rather than at the time of vesting or upon exercise. The expense can be amortized over the vesting period, and then trued up for option forfeiture on the vesting date. However, the cumulative expense never incorporates changes in option value due to stock price movements or actuarial updating of employee early exercise or forfeiture after vesting. That is, the contribution of each option to the company's compensation expense is estimated using the grant-date fair-value-based method and not "marked-to-market" again for the duration of the option term.

Although this approach is very problematic, it seems likely to be the standard. In issuing employee stock options, the company creates a contingent claim against its assets on the grant date some time during the year. Even by the time the company reports income at year-end the grant-date valuation could be stale.

Consider a dramatic but credible example: Suppose a company issues typical stock options that are valued at \$50 million net of vesting condition discounts early in the year, when the stock is worth \$100. The stock declines to \$40 resulting in options with a year-end "fair-value" of \$1 million. The company would still recognize a \$50 million charge against earnings, and it can never true up the grant-date valuation. Even at exercise the company only adjusts income to account for the difference between the estimated tax benefit and the actual tax benefit in the case of non-qualifying options.

Grant date accounting is understandable if, at the grant date, the company purchases options on its own stock from a third party at arms length to meet the obligations of its employee stock option grants. That is, the company could arrange to purchase call options with the same terms as the granted options. The purchased options may be classified as equity, provided they meet all of the criteria of EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled, in, a Company's Own Stock*. This would allow the company to exercise its options in lock step with employee exercise. The payment to the third party would be a direct reduction of equity (paid in capital) and assets on the balance sheet. This type of arrangement essentially transfers the counterparty risk over the option term to a third party and there would be no reason to recognize an expense after the grant date. In the absence of such an arrangement, shareholders retain the risk of the contingent claim, with no accounting recognition of the risk retention. Although grant date expensing does not create the valuation risk transfer/retention issue, it highlights the need for risk-averse companies to seek solutions with financial institutions that are geared to handle the valuation risk.

Both of the above-mentioned core issues relate to paragraphs C66 and C67 of the proposed Statement, which intends to answer the question: "What If It Is Not Possible to Reasonably Estimate Fair Value at the Grant Date?" FAS 123 states in paragraph 22 that a company should estimate fair value at the first date that it is possible to do so. The proposed Statement amends the FAS 123 provision to require that a company report intrinsic value rather than fair value at each reporting date until exercise. FASB amended the provision out of concern for "unintended consequences." That is, to minimize the expense, companies might choose a date for reasons other than valuation tractability. Ironically, the amended provision might be a device that many companies would prefer to employ. Although the variable intrinsic value accounting ignores time value, it partially recognizes the risk to shareholders.

Convergence Issues

The third core issue is convergence. The FASB proposed Statement differs from IFRS 2 with regard to a few areas:

- i. Compensatory option awards to non-employees (e.g., directors, associates and other consultants) are not covered by the proposed Statement, but rather by Issue 96-18, which potentially differs from the IASB standard with respect to the date of fair value measurement.
- ii. The default requirement for non-public companies under the proposed Standard is to report compensatory option-based expense using the intrinsic value method at each reporting date. This differs from the default requirement under IFRS 2, which is the same for non-public companies as it is for public companies.
- iii. The treatment of "Type III" modifications of awards (e.g., a weakening of performance conditions) is the same as for other modifications in the proposed Statement but differs from the treatment in IFRS 2.

- iv. The distinctions between liabilities and equity, and accounting for financial instruments with characteristics of both, are not entirely convergent but are moving in that direction as part of FASB's ongoing project on the matter.
- v. The accounting for income tax effects of employee stock options differs from the international standard.

The default requirement for non-public companies may be more of a semantic difference, since IFRS 2 includes an escape hatch similar to paragraphs C66 and C67. As with the treatment of instruments that have characteristics of both liabilities and equity, the treatment of Type III modifications may yet be reconciled as a result of FASB's ongoing work.

The area with the most far-reaching consequences is the accounting for the income tax effects of employee stock options. In the United States and certain other tax jurisdictions, IFRS 2 requires that a deferred tax asset be recognized only when the options have intrinsic value that could be deductible for tax purposes. Therefore, a company that grants at-the-money options would not recognize tax effects until the award is in-the-money.

FASB, on the other hand maintains that a deferred tax benefit should be recognized at the time of the grant based on fair value. At the date options expire due to exercise or forfeiture, fair value and intrinsic value are the same. This could be problematic for companies that need a consistent treatment. The approach taken in the proposed Statement (in accordance with FAS 123) is that the difference between book and tax accounting results from different measurement dates rather than different measurement bases.

FAS 123 requires that the company set up a deferred tax asset at the grant date. Thereafter, changes in the stock price do not affect the accounting for the deferred tax asset until realization of the compensation cost. In the interim, the company only reduces the deferred tax asset if it is likely that future taxable income will not be sufficient to recover the deferred tax asset in the periods that the tax deduction will be recognized. In contrast, IFRS 2 marks the deferred tax asset to market at each reporting date during the option term.

Consider an example where the fair value of options granted on January 1, 2005 is \$1,000,000 and the company recognizes the expense over the vesting period, which ends on December 31, 2007. The employee exercises the option on January 1, 2009 and recognizes a gain of \$1,250,000. The company gets a corresponding \$1,250,000 tax deduction. At a 40 percent tax rate, the company tax benefit is \$500,000. The excess tax benefit is \$100,000 (that is, 40 percent of \$1,250,000 minus \$1,000,000). FASB's approach has the first \$400,000 of tax benefit flowing through the income statement and the \$100,000 excess credited to the balance sheet (paid-in capital). IASB's approach recognizes the entire \$500,000 benefit on the income statement with each reporting period during the option's term reflecting changes in the expected tax benefit based on changes to the base - the company's stock.

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