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New Rules Regarding the Expensing of Compensatory Stock Options Are Now in Effect

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Introduction

The Financial Accounting Standards Board ("FASB") released the Statement of Financial Accounting Standards No. 123 (Revised 2004) ("FAS 123(R)", on December 16, 2004. FAS 123(R) revises FASB Statement No. 123 ("FAS 123"), originally issued in 1995, and supersedes APB Opinion No. 25, issued in 1972.

APB Opinion No. 25 has generally been relied upon for years by privately held companies to avoid expensing compensatory stock options. The intrinsic valuation method set forth in APB Opinion No. 25 provided that no compensation cost would be recognized for stock option grants having an exercise price equal to or greater than the grant date price of a share. Under the old FAS 123, FASB encouraged, but did not require, a method of accounting by which stock option awards to employees are expensed based on the "fair value" of such options as they vest. FAS 123 permitted companies to continue to account for stock options under APB Opinion No. 25. Companies were, however, required to disclose the option grants in the notes to its financial statements.

Numerous commentators claim that the failure to record grants of stock options as an expense over the vesting period resulted in the overstatement of income by companies. Many believe that

overstatement of income by companies was one of the contributing factors to the stock market downturn beginning in 2001.

The fact that the old FAS 123 did not mandate the expensing of stock options based on grant date fair value was criticized by many investors and public officials, who pressed for a tightening of the rules. Political pressure prevented FASB from making changes to the rules until the political climate changed following the stock market downturn of 2001-2002. In 2004, FASB revised its rules with the release of FAS 123(R). FAS 123(R) now requires companies to expense the fair value of employee and director stock options and other forms of stock based compensation, including restricted stock, stock appreciation rights and employee stock purchase plans. For nonpublic companies, the new rules go into effect on the first annual reporting period beginning after December 15, 2005. This means that the new FAS 123(R) rules apply to calendar-year taxpayers effective January 1, 2006.

In addition to requiring companies to expense stock options, FAS 123(R) sets forth rules for valuing stock options, recognition of expense, accounting for income tax benefits and transitioning to the new method of accounting for stock options.

New Rules Regarding the Expensing of Compensatory Stock Options Are Now in Effect

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This article provides a summary of the changes to the rules for accounting for stock options applicable to private companies. The overly simplistic examples provided in this article are for explanatory purposes only. Companies with specific questions about the new accounting rules should consult with their tax advisors or accountants.

Expensing Stock Options Under FAS 123(R)

Private companies must now measure the cost of employee service received in exchange for a stock option award based on the grant date "fair value" of the options, except in certain circumstances. FAS 123(R) provides that a stock option's fair value is measured based on (1) its observable market price or, (2) if an observable market price is not available, an estimate "using a valuation technique such as an option-pricing model." Since there is no market for shares of private companies, such companies must estimate the fair value of options using one of the pricing models.

FAS 123(R) requires that an option-pricing model used by a company to estimate the fair value of its options must, at a minimum, take into account: (a) the exercise price of the option; (b) the expected term of the option (taking into account both the contractual term of the option and expected employee behavior with respect to the exercise of the option); (c) the current price of the underlying share; (d) the expected volatility of the underlying share for the expected term of the option; (e) the expected dividends on the underlying share for the expected term

of the option; and (f) the risk-free interest rate(s) for the expected term of the option. Acceptable models include lattice models, the Black-Scholes-Merton formula and the Monte Carlo method. FASB recognizes that, in some cases, a private company may not be able estimate the fair value of its options because it is impracticable to estimate the expected volatility of the price of the underlying share. In those cases, FAS 123(R) permits a company to use the "calculated value" of its stock options. Calculated value uses the "historical volatility of an appropriate industry sector index instead of the expected volatility of the entity's share price."

In rare circumstances in which it is not possible for a company to reasonably estimate the fair value or calculated value of its stock options, such company must account for its options based upon the intrinsic value of its options, remeasured at each reporting date through the date of exercise, settlement or expiration of each option. Because of the remeasurement requirement, it is expected that very few companies will use this method.

Expense Recognition Rules

Under FAS 123(R), companies must recognize the compensation cost of stock options over the "requisite service period," which is generally the vesting period. Such compensation cost is recognized only for options that ultimately vest. A company must estimate the number of options that will not vest based upon a consideration of its historical employee turnover and its expectations about the future. At the end of the vesting period,

the company must "true up" the total compensation based upon the number of options that actually vest. See **Example 1**.

Stock option awards with graded-vesting features (e.g., an award that vests 25% per year over a four-year period) which are conditioned only upon continued service of the employee are expensed by using either (1) the straight-line method or (2) the graded-vesting method. Under the straight-line method, the fair value is spread evenly over the period beginning on the grant date and ending on the vesting date of the last separately vesting portion of the award. Under the graded-vesting method, the stock option award is considered to be multiple awards, each with its own vesting period, with each such vesting period beginning on the grant date. Once a company selects one method, it must apply the selected method to all of its stock option grants. See **Example 2**.

Accounting for Income Tax Effects of Nonqualified Stock Option Grants

Because the grant of a nonqualified stock option award presumably will lead to a future tax deduction for a company, FAS 123(R) provides that the company must record a deferred tax asset when it recognizes a compensation cost for stock options. When the option is exercised, expires or is forfeited, the actual deferred tax asset is reconciled with the tax benefit conferred upon the company. See **Example 3**.

Nonqualified stock options plans may, in certain circumstances, also be subject to Section 409A of the Internal Revenue

Code. Under Section 409A certain deferred compensation arrangements become immediately taxable to the employee upon vesting. A discussion of Section 409A is beyond the scope of this article.

Transition Rules

Public companies are required to: (1) apply FAS 123(R) to equity based compensation awards granted, modified, repurchased or cancelled in periods beginning after the effective date of implementation of the new rules (either June 15, 2005 or December 15, 2005, depending on whether a public company qualifies as a "small business issuer"); and (2) use either the "modified prospective application" or "modified retrospective application" to account for stock options granted prior to, but still unvested at, the implementation of the new rules.

Private companies must adopt FAS 123(R) for the fiscal years beginning after December 15, 2005. However, the transition rules applicable to most private companies are more favorable than those applicable to public companies. Private companies that did not follow the optional rules regarding the expensing of options in effect prior to the implementation of FAS 123(R) must apply the FAS 123(R) rules on a prospective basis only. That is, the rules will apply only to stock option and other equity based compensation awards granted, modified, repurchased or

cancelled after December 15, 2005. No expense must be recognized for earlier grants.

Any private companies that voluntarily chose to expense options prior to the implementation of FAS 123(R) must use the transition rules applicable to public companies.

Accounting for Restricted Stock Grants

FAS 123(R) does not change the method by which grants of restricted stock are accounted for. A restricted stock award is typically a grant by the company of full-value stock with vesting of such stock contingent upon continued service to the company by the employee.

A company must expense the fair value of a restricted stock grant "as if it were vested and issued on the grant date." The fair value of the restricted stock is equal to its fair value (i.e., the price at which a similarly restricted share would be issued to third parties), and is not subsequently remeasured. A company would then recognize the expense ratably over the requisite vesting period. See **Example 4**.

For income tax purposes, the Company is entitled to take a deduction for the fair value of the restricted stock in either the grant year or the year in which the restricted stock vests, depending upon whether the employee makes a Section 83(b) election. If an employee makes a

Section 83(b) election, the employer would be able to take a deduction in the grant year based on the fair value of the shares on the date of grant. If an employee does not make a Section 83(b) election, the employer would be able to take a deduction equal to the fair value of the shares on the date that such shares become fully vested.

A table showing the different rules applicable to stock option and restricted stock is found on the next page.

Trends in Equity Compensation

Recent studies and reports indicate that many companies have reacted to FAS 123(R) by reducing or eliminating stock option awards to employees and increasing grants of restricted stock. For example, a 2006 Culpepper Pay Trends Survey, available at www.culpepper.com/eBulletin/2006/MarchPayTrends.asp revealed that 73% of companies plan to make, or have made, changes to their stock option plans by reducing the use of options as compensation. The Culpepper survey also confirmed a significant reduction in the award of stock options and an increase in restricted stock awards after FAS 123(R) took effect. Other reports indicate that some companies have completely stopped the practice of offering stock options as a form of employee compensation.

A copy of FAS 123(R) is available at www.fasb.org/pdf/fas123r.pdf.

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Tables and Examples

Type of Equity Compensation	Determination of Compensation Cost	Recognition of Compensation Cost	Recognition of Deferred Tax Asset	Adjustment after Vesting
NQSO - graded vesting	Compensation cost determined using the grant date fair value or, if impracticable to estimate share volatility, calculated fair value of a share option using an acceptable option-pricing method	Use either straight-line or graded-vesting method to expense over vesting period See Example 2	Must record a deferred tax asset during vesting period See Example 3	Compensation cost and deferred tax asset must be "trued up" at the end of vesting period. At time of exercise, tax benefits in excess of deferred tax asset treated as additional paid-in capital. See Example 1 and Example 3
NQSO - cliff vesting		Use straight-line method to expense over vesting period See Example 1		
ISO - graded vesting	In rare circumstances, intrinsic value may be used	Use either straight-line or graded-vesting method to expense over vesting period See Example 2	Not applicable.	Compensation cost must be "trued up" at the end of the vesting period See Example 1
ISO - cliff vesting		Use straight-line method to expense over vesting period See Example 1		
Restricted Stock - graded vesting	Compensation cost based on the grant date per share price (i.e., the amount a similarly restricted share would be issued to third parties)	Use either straight-line or graded-vesting method to expense over vesting period	Must record a deferred tax asset during vesting period	Compensation cost and deferred tax asset must be "trued up" at the end of vesting period
Restricted Stock - cliff vesting		Use straight-line method to expense over vesting period See Example 4	Must record a deferred tax asset during vesting period	

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Example 1: Emerging Growth, Inc. (the "Company"), a calendar-year taxpayer, grants to each of its 10 employees 5,000 share options on its stock on January 1, 2006. The Company grants the options with an exercise price of \$1.00 per share, which is the current value of a share of the Company's stock. The options vest on December 31, 2009 and vesting is contingent upon continued employment of the grantee by the Company through the vesting period. The Company expects that only 6 of its employees will remain employed by the Company through the vesting period. The Company estimates the grant date fair value of the award to be \$5.00 per option using one of the accepted option-pricing models. Based on the Company's estimations, the total compensation cost of the stock options will be \$150,000 (5,000 share options * 6 employees * \$5.00 per option). On its financial statements, the Company will recognize a compensation cost of \$37,500 (\$150,000 / 4) in each of 2006, 2007 and 2008. On December 31, 2009, the Company discovers that it overestimated the forfeiture rate because 8 of the 10 employees actually remained with the company through 2009. The Company must then "true-up" the compensation cost by recognizing a compensation cost for 2009 of \$87,500 ((5,000 share options * 8 employees * \$5.00 per option) - (\$37,500 * 3)).

Example 2: Same set of facts as in Example 1, except that (i) 25% of the share options vest each year during the four-year vesting period and (ii) the company estimates that all 10 employees will remain with the Company through

the end of the vesting period and all of the employees do, in fact, remain with the company during that period. Under the straight-line method, the Company would recognize a compensation cost of \$62,500 per year for the stock options during the vesting period (5,000 share options * 10 employees * \$5.00 per option / 4 years). Under the graded-vesting method, the Company would recognize a compensation cost of \$130,208.33 in 2006 ((1,250 options vesting in year 1 * 10 employees * \$5.00 per option / 1 year) + (1,250 options vesting in year 2 * 10 employees * \$5.00 per option / 2 years) + (1,250 options vesting in year 3 * 10 employees * \$5.00 per option / 3 years) + (1,250 options vesting in year 4 * 10 employees * \$5.00 per option / 4 years)). The 2007 compensation cost under the graded-vesting method would be \$67,708.33 ((1,250 options vesting in year 2 * 10 employees * \$5.00 per option / 2 years) + (1,250 options vesting in year 3 * 10 employees * \$5.00 per option / 3 years) + (1,250 options vesting in year 4 * 10 employees * \$5.00 per option / 4 years)). The 2008 and 2009 compensation costs under the graded-vesting method would be \$36,458.33 and \$15,625, respectively.

Example 3: Same set of facts as in Example 1. Assume that (i) the Company's effective income tax rate is 35% and (ii) the stock options are nonqualified. In each of 2006, 2007 and 2008 the Company will recognize a compensation cost of \$37,500 for financial reporting purposes. In each of those years, the Company would also recognize a deferred tax asset of \$13,175

(\$37,500 * 0.35). In 2009, the Company will recognize a compensation cost of \$87,500 and, therefore, will recognize a deferred tax asset of \$30,625 (\$87,500 * 0.35). At the end of 2009, the total deferred tax asset with respect to the nonqualified stock options would be \$70,000. Assume that in 2010 the price per share of the Company's stock is \$10.00 and each of the employees exercises his options. The actual compensation cost (and tax deduction) in respect of the exercised options in 2010 will be \$360,000 (5,000 share options * 8 employees * (\$10.00 per share - \$1.00 per share exercise price)). Assuming that the Company has sufficient taxable income to realize the deduction, the tax benefit realized by the Company in 2010 is \$126,000 (\$360,000 * 0.35). The Company then must record the excess of the actual tax benefit over the total deferred tax benefit, in this case \$56,000 (\$126,000 - \$70,000), as additional paid-in capital.

Example 4: The Company grants 1,000 shares of restricted stock to each of its 10 employees, which stock will vest in 3 years. The Company estimates that the grant date value of its stock to be \$5 per share. The grant date value of the share award is \$50,000 (1,000 * 10 * \$5). Because the vesting period is 3 years, the Company will recognize \$16,667 of compensation cost for each of the three annual periods following the grant. As with the expensing of stock option grants, the Company must also recognize the corresponding deferred tax asset over the three year period.

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