FAS 123R: Accounting for Stock Options

< Tips for an Increasingly Complex Task >

by Greg Regan, CPA & Matt Lombardi, CPA

With apologies to Baskin-Robbins, stock options seem to be available in at least 31 flavors. Consider the following varieties: premium options (strike price above grant date stock price); purchased options (employee pays a fraction of the strike price at grant); indexed options (strike price varies based upon an index); and options with performance conditions (e.g., vesting or share award depending on growth in earnings per share).

These compensation measures were designed to align employee performance with the company's success. The result, however, is a tremendously complex world for those faced with accounting for these instruments.

WHAT GAAP IS APPLICABLE TO STOCK OPTIONS?

FAS 123R, Share Based Payment, provides the accounting guidance for a broad spectrum of compensation instruments, including equity shares, equity share options, other equity instruments or liabilities that are based, at least in part, on the price of the issuer's shares.

FAS 123R revised FAS 123, replaced APB 25 and amended FAS 95. However, it did not modify the accounting promulgated by Emerging Issues Task Force 96-18, impacting equity awards to non-employees, or SOP 93-6, relating to employee stock ownership plans.

FAS 123R requires companies to recognize the cost of employee services received in exchange for share-based payments based on the respective grant date fair value of the award. This objective is consistent with FASB's theme that the "economic consequences," or fair value, of transactions be reflected in financial statements. Subsequent to FAS 123R, both the SEC and the PCAOB issued guidance concerning the implementation of FAS 123R (see Staff Accounting Bulletin No. 107, *www.sec.gov/interps/account/sab107.pdf*, and PCAOB Audit Practice Alert No. 1, *www.pcaobus.org/Standards/Staff_Questions_and_Answers/2006/07-28_APA_1.pdf*).

Still, as many companies complete their first year of compliance with the new standard, questions abound.

KEY IMPLEMENTATION ISSUES OF FAS 123R

One of the first steps is determining the most suitable valuation model. There are two primary models in use: the Modified Black-Scholes model and the binomial lattice model.

The MBS model uses a pre-established equation to

Tax Rules for Employee Stock Options Continue to Evolve

by Michael Gray, CPA

Despite the recent scandals and the accounting challenges of managing employee stock options, they continue to be widely used. And there have been many federal court cases involving taxpayers contesting the tax consequences—as the IRS sees them—of their actions, especially relating to the alternative minimum tax for incentive stock options. The courts have upheld the IRS in almost all of these cases.

So, it's important that clients receive continuing support to navigate the hazards of managing employee stock options.

Here are a few highlights relating to employee stock options that have developed over the last couple years.

NEW RULES FOR NONQUALIFIED DEFERRED COMPENSATION PLANS

IRC Sec. 409A, effective for taxable years beginning after Dec. 31, 2004, includes new restrictions for nonqualified deferred compensation plans. The IRS issued guidance in Notice 2005-1 early in 2005 and proposed regulations (IRS REG-158080-04) Sept. 29, 2005.

An option priced below fair market value as of the grant date (except Employee Stock Purchase Plans priced according to their requirements) is considered to be nonqualified deferred compensation.

Under these rules, a 20 percent tax penalty applies to what would otherwise be deferred compensation that fails the requirements of IRC Sec. 409A(a)(1)(B). Also, the amount that would otherwise be deferred compensation is includable in taxable income. [IRC Sec. 409A(a)(1)(A)].

An interest penalty also applies to the amount of compensation previously deferred (presumably computed from the later of the grant date or the vesting date and annually thereafter until the compensation is taxable). The interest rate is the rate used for underpayment of tax plus 1 percent. [IRC Secs. 409A(a)(1)(B)(i)(I) and 409A(a)(1)(B)(ii)]. Interest would mostly apply to non-qualified stock options (NQOs) that were granted before 2005 and fail the exception tests for IRC Sec. 409A.

Proposed regulations include guidelines for determining the fair market value of company stock for publicly traded and private companies. [IRC Secs. 1.409A-1(b)(5)(iv)(A) and 1.409A-1(b)(5)(iv)(B)]. In most cases, private companies that issue employee stock options should have their stock appraised at least annually.

The IRS has announced an additional one-year extension of the effective date of the final regulations until Jan. 1, 2008. This should provide additional time for preparing written documentation for nonqualified stock option grants, except for certain backdated transactions (U.S. Treasury Notice 2006-29). Although this extension may help clean up pricing for unexercised options, it may not help disqualified options exercised during 2006.

BACKDATING CONSEQUENCES

Here are four tax issues of concern for backdated options:

1. ISOs and ESPPs may only be granted to employees. [IRC Secs. 422(a)(2), 423(a)(2)]. If the employer backdated the employee's start date, the individual may not have actually been an eligible employee. Therefore, the option will not qualify as an ISO or ESPP and will be taxed as a non-qualified stock option.
2. ISOs and ESPPs must be priced based on the fair market value on the grant date (or exercise date for ESPPs). [IRC Secs. 422(b)(4), 423(b)(6)]. If the option fails the pricing test on the actual grant date, it will be taxed according to the rules for non-qualified stock options.
3. If a non-qualified stock option has an option price less than the fair market value on the grant date, the option is probably subject to the rules for non-qualified stock options under IRC Sec. 409A. [Proposed U.S. Treasury Regs. Sec. 1.409A-1(b)(5)(i)(A)]. This means the income from the option will not qualify for tax deferral and will be subject to a 20 percent penalty tax.
4. A non-qualified stock option, with an option price less than the fair market value on the grant date, won't qualify as "performance-based compensation" for the $1 million limitation of deduction of compensation paid to a covered employee of a publicly-held corporation. [U.S. Treasury Regs. Sec. 1.162-27(e)(2)(vi)(A)]. The limit applies to the CEO and the four highest-paid officers other than the CEO. This limitation could result in the disallowance of significant deductions of compensation relating to the exercise of stock options.

determine an estimated fair value. Conversely, a binomial lattice model provides a framework for computing the fair value using discounted cash flows.

Under the two models, FAS 123R generally requires—at a minimum—the consideration of: the exercise price of the option, the expected term of the option, the current price of the underlying share, the expected volatility of the price of the underlying share, the expected dividends on the underlying share and the risk-free interest rate.

For purposes of FAS 123R, the Black-Scholes model is modified to use the "expected term" of the option as opposed to its contractual term, if different. This is permitted due to the differences between employee stock options, which generally may be exercised anytime after vesting, and options that are traded on the open market, which are typically not exercised prior to expiration (FAS 123R Sec. A26).

This modification raises an important consideration relative to the model decision: What are the key inputs to the valuation of an option, and how is the valuation sensitive to these factors? Some general guidelines include:

Input	Difficulty to Determine	When Input Increases, Option Value:
Current Market Price	Low	Increases
Strike Price	Low	Decreases
Risk-Free Rate	Medium	Increases
Dividend Yield	Medium	Decreases
Expected Term	High	Increases; due to longer time to realize gains without downside
Expected Volatility	High	Increases; due to higher potential for market price appreciation

The decision is driven, in part, by how these inputs are determined. In general, many small- to middle-market companies have utilized the MBS model. However, large companies, such as Google and Oracle, are employing the MBS. In practice, this model appears to be simpler and more cost effective, which is in part due to existing familiarity with the prior valuation practices typically applied under FAS 123.

However, some studies have found that the MBS results in higher fair values and consequent expenses when compared with a lattice model [Rudkin, Ronald. April 2006. *Valuation of Employee Stock Options and Other Equity-Based Instruments: Short Term and Long-Term Strategies for Complying with FAS 123R and for Optimizing the Performance of Equity-Based Compensation Programs under the New Standard*. Pg 1; and Plank, Jeffery. Wynn, Bruce. *Expensing Stock Options under FAS 123(R)*].

As for the lattice model, FAS 123R suggests it "more fully reflects the substantive characteristics of a particular employee share option" (FAS 123R Sec. 15). The explanation is that lattice models have the capacity to vary the fair value inputs over time, whereas the MBS utilizes constant values for the life of the instrument.

This capacity causes the SEC's Staff Accounting Bulletin No. 107 to note that the lattice model must be used in certain situa-

Transition relief has not been extended for any stock option or stock appreciation right for publicly traded corporations issued to persons subject to disclosure requirements under the Securities Exchange Act Sec. 16(a) and where a financial expense was not timely reported on financial statements or reports when the options or rights were issued. The issuing corporations had until Dec. 31, 2006, to bring the options or rights into compliance with IRC Sec. 409A without being subject to the 20 percent penalty. (IRS Notice 2006-79.)

NEW REFUNDABLE MINIMUM TAX CREDIT

The Tax Relief & Health Care Act of 2006 Sec. 402 adds IRC Sec. 53(e) to permit a refundable credit for certain old unused minimum tax credits. The refundable credit will be available for calendar years 2007 through 2012 for individual taxpayers.

Minimum tax credits that are more than three years old are eligible for the AMT refundable credit. For 2007, minimum tax credit carryovers attributable to tax years before 2004 would be eligible.

Since the refundable credit is phased out based on the ratio to phase out personal exemptions, higher-income taxpayers won't be eligible for the credit.

NEW REPORTING REQUIREMENTS FOR ISOs, ESPPs

Starting in 2007, under changes enacted in the Tax Relief & Health Care Act Of 2006, employers will be required to provide information as prescribed by the IRS in regulations first to the employee by Jan. 31 of the year following the transfer of shares relating to the exercise of an incentive stock option. A copy of the information return will also be filed with the IRS, presumably by Feb. 28 like other information returns. (The first information returns must be issued to employees by Jan. 31, 2008, for 2007 exercises.)

PRICING FOR ESPPs

The new standard for pricing ESPPs may become 95 percent of fair market value on the grant date, based on the FASB statement that no compensation needs to be reported on a company's financial statements—provided ESPP options are priced with a discount from fair market value on the grant date of 5 percent or less from the market price. [Statement of Financial Accounting Standards No. 123 (revised 2004), Paragraph 12].

CHANGES FOR SECURITIES AND EXCHANGE ACT OF 1934 Sec. 16(b)

The SEC has issued changes to Rule 16b-3 that were effective Aug. 15, 2006, that state the waiting period for insider shares to vest under IRC Sec. 83(a) may be eliminated. Consult with legal counsel about how these changes will apply to your clients.

CONCLUSION

The tax laws and the economic environment for employee stock options continue to evolve. Tax advisers who work with option holders and employers that issue employee stock options must be diligent to remain on top of the latest developments. CPA

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tions. For example, if an option exercise is dependent upon a certain level of share price increase (performance condition), only the lattice model is able to take the requisite underlying market conditions into account. Some examples of companies that have employed this model include Cisco Systems Inc., Procter & Gamble and Qualcomm. However, some companies may judge the benefits of this sophistication to be counter-balanced by the commensurately higher implementation and audit costs.

It's worth noting that it is permissible to switch between models in appropriate circumstances. In SAB 107, the SEC noted it would not consider this type of event to be a change in accounting principle.

VALUATION INPUT ESTIMATION: BEST PRACTICES

Even though the fair-value estimate should reflect assumptions utilized by marketplace participants, both FASB and the SEC have noted that it is not realistic to expect the models to reliably predict actual future events (See FAS 123R Sec. A12 and SAB 107).

Of all the inputs, the two most difficult to estimate are Expected Term and Expected Volatility. At least one reason for this expectation is that these inputs are to be estimated on a forward-looking basis. In other words, while historical experience is generally the starting point for these estimates, the experience should be modified to reflect any current assumptions indicating that future conditions may be different.

Here are some recommendations concerning factors to consider in estimating these values (note that FAS 123R and SAB 107 both list other relevant factors):

Expected Term

- Examine historical exercise patterns, the post-vesting cancellation period, the vesting length, blackout dates and patterns of the stock price.
- Aggregate awards into homogeneous groups. For example, the behavior of grants to executive management may be distinct from awards to managers. (For an example, see Oracle's 2006 10-K filing, *www.oracle.com/corporate/investor_relations/10k-2006.pdf*).
- Note that SAB 107 sets forth a simplified method for "plain vanilla" options based upon the following formula: one half of the combined total of the vesting term plus the original contractual term. However, it is anticipated that this method may only be applied relative to option grants made before Dec. 31, 2007.
- In any event, the lower bound of the expected term is the vesting period.

Expected Volatility

- Determine the implied volatility of publicly traded company options or relevant comparables, but do not use indexes. The latter approach may be particularly relevant for emerging companies. (For example, see the recent S-1 filings of Aruba Networks, *www.secinfo.com/dr6nd.vFg.5.htm*, and Veraz Networks, *www.secinfo.com/dr6nd.vd8.w.htm*).
- Focus on those options that have similar terms and strike prices to ensure consistency. It is also preferable

if the traded options have an active market. If not, consider aggregating weekly trading volume.
- Consider if historical volatility is a reliable indicator of long-term volatility in light of mean reversion tendencies (FAS 123R Sec. 58.).
- Note that SAB 107 addresses circumstances in which exclusive reliance on either historical or implied volatility is appropriate.

In addition, it's necessary to compute the number of options that are expected to vest. In other words, there is a certain probability that a percentage of options will be forfeited. Although this variable does not impact the valuation of an individual option, it does directly impact total compensation expense incurred. This estimation is a change from FAS 123, which permitted the inclusion of all options in the original estimation. When making this estimate, carefully consider factors affecting the probability of exercise, including the employee turnover rate, which may in turn be impacted by the expected stock price.

WHAT ELSE?

Other hot issues to be aware of related to FAS 123R:

- The determination of the grant date has received a lot of attention. One key criteria of FAS 123R is that the employee has to benefit from changes in the stock price beginning on the grant date.
- Whether or not the award includes a non-substantive service period. In this case, the award should be recognized over the identifiable service period.
- Still other items to consider include graded vesting and equity restructurings that trigger award modifications.

RECOMMENDATIONS TO REDUCE FUTURE EXPENSE

The table (Page 13) demonstrating the impact of each of the key inputs can be leveraged to brainstorm methods to reduce future expense. For instance, reducing the contractual term of an option may in turn decrease the expected term.

Another suggestion would be to adjust the strike price of the option so that the instrument is no longer "at-the-money" at the grant date (otherwise known as premium options).

Other, more employee-favored, alternatives include decreasing the length of the vesting period or increasing vesting frequency.

Finally, companies may consider utilizing other equity instruments such as maximum value options, which cap the spread between the stock price and strike price, or restricted stock.

UNDERSTANDING IS KEY

If one thing has become clear with the adoption of FAS 123R, it's that stock-option accounting remains incredibly complex. Beginning with the determination of an acceptable valuation model and through the process of establishing reasonable valuation inputs, companies are faced with a multitude of ongoing questions.

Answers to these questions are in part determined through an understanding of all awards granted, an analysis of acceptable valuation models and an evaluation of relevant historical option information, comparable peer data and pertinent market information. These matters aside, understanding other basic complexities of stock-option accounting—such as appropriate award granting practices—may keep you and your company out of trouble. CPA

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