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The SEC Comes Down Hard on Stock Options: FAS Statement 123(r) Interpreted

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If you thought you were through the worst of Sarbanes-Oxley compliance, the SEC has a surprise in store for you.

The SEC has announced its position on stock-based compensation and other payments in the recently issued Staff Accounting Bulletin No. 107. SAB 107 provides interpretive guidance on the Financial Accounting Standards Board Statement No. 123(r) (the "Statement") as well as providing specific examples in applying standard principles of financial economics for the purpose of estimating option values. **The Statement requires the issuer to recognize the cost of employee services received in share-based payment transactions, thereby reflecting the economic consequences of those transactions in their financial statements.**

Stock options and other stock-based arrangements are the frequently used methods of compensation for both public and private entities. The Sarbanes-Oxley Act of 2002 was enacted as a result of public investors' need for transparency of a company's financial statements. This transparency includes the expensing of stock-based arrangements which has become crucial to understanding and evaluating director and executive officer compensation.

To date, two accounting methods have been available for use in valuing stock-based payment transactions for public entities: the fair-value-based method as identified in the Statement, and the intrinsic-value method. The Statement seeks to **eliminate** the intrinsic-value method so that the accounting method used for valuing stock-based payment transactions is consistent for all public entities. The Statement adopts the premise that the recipient of any stock-based compensation has performed services in consideration of that award and therefore requires the issuer to quantify the cost of employee services received in exchange for a stock-based award, based on the fair value of the award on the date of grant. The objective of the fair-value-based method is to estimate the cost to the company of the award as a payment for employee services. That cost will be recognized over the requisite service period, specifically, the period in which the employee is expected to provide service in exchange for the award.

It goes without saying that there will now be a complete disconnect between the accounting reporting of stock-based awards by the issuer and the tax treatment of those awards to the recipient.

Essentially, the Statement requires companies to measure the fair value, as opposed to the intrinsic value (also known as the spread) of options and other equity awards at the time of grant using a valuation method such as Black-Scholes-Merton and then expense the award in the following manner:

- For options and other equity-based awards (including awards that have performance-based vesting), the fair-value of the award is fixed at the time of grant and accrued over the vesting period. Therefore, stock appreciation rights to be settled in stock and awards with performance-based vesting (when vesting is tied to revenue or EBITDA) will no longer be subject to variable accounting treatment as traditional options with time-based vesting.

- For awards that are settled in cash, such as cash stock appreciation rights, the fair value of the award will be subject to variable accounting treatment, meaning that the value will not be fixed for the life of the award but will be re-measured each quarter.[1]

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[1] Goodwin Procter LLP Information Newsletter, December 28, 2004, pg. 1, 2.

With respect to share-based payment transaction with non-employees, such as directors, SAB 107 clearly explains that the Statement "establishes fair value as the measurement objective in accounting for all share-based payments and requires that an entity record the value of a transaction with a non-employee based on the more reliably measurable fair value of either the good or service received **or** the equity instrument issued."[2]

Nonpublic entities that use the intrinsic value method prior to becoming a public entity must begin measuring all share-based payments at their fair value. SAB 107, however, states that a nonpublic entity should not retrospectively apply the fair-value method to its awards prior to the date it became a public entity. Accordingly, for awards that are fully vested but not exercised prior to becoming a public entity, there would be an incremental amount of measured cost for the difference between fair value and intrinsic value. The SEC believes the newly public entity should explain the change in accounting policy and valuation for its equity awards in the MD&A of its most recent periodical report.[3]

In order to meet the Statement's fair-value measurement objective regarding options and other alternatives, company management will now be required to develop certain estimates regarding the expected volatility of its share price and the exercise behavior of its employees. In order to avoid this type of estimating process, companies may wish to consider using non-derivative stock-based awards, such as restricted stock which can be less dilutive to shareholders and provides value even in a depressed market.

Both the Statement and SAB 107 clearly dictate that companies are required to use all available information at the time of the grant to estimate the relevant parameters for their valuation methods. The SEC also believes that the Statement recognizes that certain estimates of future outcomes will not always equal the estimated future realizations of those outcomes and companies should therefore consider its own circumstances when selecting the valuation method or model as long as it is consistent with the fair-value measurement objective.

The Statement will be effective for public companies (other than small business issuers) for fiscal year starting after June 15, 2005 and therefore reportable for most companies whose fiscal years begin January 1, 2006. For small business issuers and private companies, the Statement will be effective starting with the first interim period commencing after December 15, 2005, or in their first annual report on Form 10-K. Companies, other than small business issuers, with a June 30th year-end, however, must comply with the Statement.

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[2] Release No. SAB 107, pg. 6.
[3] Release No. SAB 107, pg. 10.