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UPDATE ON CLOSE OF FASB'S PUBLIC COMMENT PERIOD

On June 30, 2004, the Financial Accounting Standards Board (FASB) closed its public comment period for the Exposure Draft (ED) on Share-Based Payment (SBP). During the comment period, FASB received over 7,000 letters and held public roundtable discussions in Palo Alto, California and Norwalk, Connecticut. In general, there were very few surprises at the close of the comment period. As expected, there were pleas by the business community, as well as congressional members and the chief accountant of the SEC, for FASB to take additional time to consider input and to ensure expense recognition for the value of employee stock options is fair and reasonable. As a result, FASB may delay implementation and consider slight changes to the ED, such as:

Potential Changes to Exposure Draft
• Alter option valuation guidance to narrow the range of "fair value" outcomes
• Retain the exception currently available under FAS 123 for broad-based employee stock purchase plans that provides discounts of 5% or less
• Retain a choice between straight-line and front-loaded accruals for installment-vesting grants
• Permit grant date valuations for options with reload features
• Provide symmetry for tax benefits/deficits either to operations or equity
• Allow retrospective restatement for periods prior to adoption
• Provide exemptive relief for private companies or small issuers

Since it appears likely that option expensing will be adopted and the final standard will be similar to the ED issued on March 31, 2004, it is important for employers to develop a prospective strategy. The following are measures that employers should consider in anticipation of the final adoption of the standard:

Measures to Consider in Anticipation of Final Standard

- Revisit the design of all stock-based incentive programs and consider long-term incentive alternatives in light of changes in accounting treatment and increasing pressure for share conservation from the investment community
- Consider and review the cash flow, accounting expense and dilution impact of all plans in order to be prepared for the implementation of the standard
- Assess the "perceived" value of stock-based vehicles among employees and conduct a cost-benefit analysis of current and potential alternatives for stock-based and other long-term incentives
- Identify, investigate and procure a valuation model to be used for determining fair value. FASB has stated its preference to be a lattice-based option valuation model (e.g., binomial)
- Collect company-specific data necessary for valuation inputs. Potential further guidance from FASB coupled with appropriate company-specific historical data will likely narrow the range of "fair value" outcomes
- Develop a back-up plan for what to do in 2005 if the effective date is delayed until, e.g., 2006
    - The back-up plan for equity grants in 2005, under the delayed implementation scenario, should carefully consider grant terms, such as vesting and performance conditions, since it is likely the grant will mature under the new accounting standard
- Consider whether early adoption of FAS 123 by 12/14/04 makes sense if the goal is to make certain the company can restate prior periods for stock option expense

In short, companies should understand the proposed rules and identify a compensation strategy to address the hurdles and opportunities of the proposed standard.

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This letter is intended to alert compensation professionals about developments that may affect their companies. General questions about this letter can be addressed to Aaron M. Miller in our New York office at 212-986-6330 or by email at ammiller@fwcook.com. This letter and other published materials are available on our website, www.fwcook.com.