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FASB Decides on
<u>Effective Date for Option Expensing</u>

"Re-Exposure" of Proposed Rules Not Necessary
Staff Receives Clearance to Proceed Drafting Final Standard

The Financial Accounting Standards Board (FASB) made several important tentative decisions over the last week in regard to the effective date for its project on expensing employee equity-based compensation. Mandatory stock option expensing for public companies would commence on a "modified prospective" basis for quarterly reporting periods beginning after June 15, 2005, and for annual reports including those affected quarters. Depending on a company's fiscal year end, the proposed new effective date would result in either a 3- or 6-month deferral of the new rules from the FASB's original proposal of fiscal years beginning after December 15, 2004 (6-month deferral for calendar year companies), or a 3-month acceleration of the new rules for companies with fiscal years ending September, October, or November of 2005. However, the FASB has provided significant flexibility in adopting and transitioning to the new rules, and predicts that many public companies will elect to adopt early and/or retrospectively restate the initial year of adoption and possibly all reporting periods presented. Mandatory stock option expensing for nonpublic companies that have not previously adopted the fair value expensing rules would become effective on a "prospective" basis for fiscal years beginning after December 15, 2005, consistent with the FASB's original proposal (there would be an effective 12-month deferral of the new rules for "small business issuers").

Also during the last week, the FASB considered and rejected an alternative stock option valuation technique proposed by the high-technology sector, decided that additional field testing (sought after by many constituents during the public comment period and roundtable discussions) and "re-exposure" of the proposed standard (sometimes necessary when significant changes are made to the original proposal) would not be necessary, and directed its Staff to proceed drafting the final standard which is expected to be issued in December of this year.

<u>Effective Date and Transition</u>*

<u>*General Rule*</u> – For public companies, FAS 123r would become effective on a modified prospective basis for quarterly reporting periods beginning after June 15, 2005 (the "effective date"). Modified prospective means that FAS 123r would apply to equity-based compensation granted, modified, or settled in cash during reporting periods beginning after the effective date, and also to the nonvested portion of awards outstanding as of the effective date (provided the awards were granted or modified in fiscal years beginning after the original December 15, 1994 effective date of FAS 123). Compensation cost for outstanding nonvested awards would be based on previously estimated grant date fair values and attribution methods used for recognition or pro forma footnote disclosures under FAS 123. Changes to previously reported footnote costs would be precluded.

* Original FASB Statement No. 123 is referred to as "FAS 123," and amended FASB Statement No. 123 (that is, the proposed new standard) is referred to as "FAS 123r"

FAS 123r would apply to annual reports in proportion to the number of quarterly periods beginning after the June 15, 2005 effective date. For calendar year companies, this means that compensation cost would be recognized in annual reports under FAS 123r for the final two quarters of 2005. For the first two quarters of 2005, compensation cost would be reported either in the pro forma footnote disclosures (for companies not previously adopting the recognition provisions of FAS 123) or recognized in the income statement for previous FAS 123 adopters. Companies with fiscal years ending August 31, 2005 or earlier presumably would not have to recognize compensation cost in 2005 annual reports, because no quarterly reporting periods would begin after the June 15, 2005 effective date. The table below illustrates how the effective date of FAS 123r would apply to companies with different fiscal year ends:

Quarterly Reporting Period When FAS 123r Would Be Effective					
Fiscal Year End	**1st Quarter**	**2nd Quarter**	**3rd Quarter**	**4th Quarter**	
August 31, 2005					No change
September 30, 2005				XXX	
October 31, 2005				XXX	3-month acceleration of new rules from original proposal
November 30, 2005				XXX	
December 31, 2005			XXX	XXX	
January 31, 2006			XXX	XXX	6-month deferral of new rules from original proposal
February 28, 2006			XXX	XXX	
March 31, 2006		XXX	XXX	XXX	
April 30, 2006		XXX	XXX	XXX	3-month deferral of new rules from original proposal
May 31, 2006		XXX	XXX	XXX	
June 30, 2006	XXX	XXX	XXX	XXX	No change

<u>*Early Adoption of FAS 123r*</u> – For all public companies, the FASB encourages early adoption of FAS 123r to the beginning of the fiscal year in which the effective date occurs (January 1, 2005 for calendar year companies). Earlier adoption for prior periods also would be encouraged to the extent quarterly/annual reports have not yet been filed.

<u>*Retrospective Restatement for Year of Adoption*</u> – For public companies not previously adopting the recognition provisions of FAS 123, FAS 123r would permit (but not require) companies to restate (but not reissue) earlier quarters in the year of adoption using previously estimated grant date fair values calculated for pro forma footnote disclosures under FAS 123. For calendar year companies, this means that amounts reported in the pro forma footnote disclosures for the first two quarters would be recognized as compensation cost in the 2005 annual report.

<u>*Retrospective Restatement for All Periods Presented*</u> – For public companies not previously adopting the recognition provisions of FAS 123 on a retrospective basis, FAS 123r would permit the retrospective restatement of all reporting periods presented using previously estimated grant date fair values calculated for recognition or pro forma footnote disclosures under FAS 123.

<u>*Nonpublic Companies and Small Business Issuers*</u> – For nonpublic companies not previously adopting the fair value provisions of FAS 123, FAS 123r would be effective on a prospective basis for equity-based compensation granted, modified, or settled in fiscal years beginning after December 15, 2005, with no application to the nonvested portion of awards outstanding as of that effective date. Small business issuers would be required to apply FAS 123r for reporting periods beginning after December 15, 2005, using the same transition provisions that apply to other public companies.

Other Tentative Decisions

The FASB's most significant tentative decisions since our last mailing on this subject are summarized below:

In General – FAS 123r would require equity-based compensation issued by public companies to employees to be recognized as compensation cost net-of-tax over the requisite service/vesting period based on modified grant-date fair value methodology, with no preference for binomial lattice-based models over closed form Black-Scholes-Merton formulas. Compensation cost would not be recognized for awards that fail to vest because of "service" or "performance" vesting conditions, but no reversal of previously recognized compensation cost would be permitted for failure to attain "market" vesting conditions (such as stock price or total shareholder return performance goals). Compensation cost for equity-based compensation that provides for cash settlement (that is, "liability" awards) would be based on variable fair value accruals until award settlement.

Awards with Graded Vesting – FAS 123r would permit companies to choose between an "accelerated accrual" or "straight-line" amortization approach when recognizing compensation cost for awards with graded service vesting schedules, regardless of the valuation technique used to estimate fair value (such as using tranche-specific option lives in a lattice model). That is, neither approach would be regarded as "preferable."

Income Taxes – FAS 123r would retain the FAS 123 approach for accounting for income tax effects. If the actual tax deduction for an award is more than the compensation cost recognized for that award, the tax benefit would be recognized as additional paid-in capital on the balance sheet. If the actual tax deduction is less than the compensation cost recognized, the excess would first be offset by any excess tax benefits previously recognized as additional paid-in capital (accumulated since the original December 15, 1994 effective date of FAS 123), and the remainder would be recognized as increased income tax expense on the income statement. On the statement of cash flows, excess tax benefits would be reported as a financing cash inflow on a "gross" basis (not "net" of tax deficiencies).

Variable Awards Under Opinion 25 – Equity-based compensation that was previously accounted for as "variable" under Opinion 25 (such as "repriced" stock options, and stock-settled stock appreciation rights and awards with performance vesting criteria) would effectively become "fixed" as of the effective date based on previously estimated grant date fair value and attribution methods used for pro forma footnote disclosures under FAS 123. As mentioned above, compensation cost for cash-settled liability awards would be based on variable fair value accruals until award settlement.

Deep Out-of-the-Money Options – Some companies are considering accelerating the vesting of nonvested underwater stock options prior to the effective date of FAS 123r to avoid recognition of compensation cost. The FASB has indicated it would not prohibit this practice. However, once FAS 123r becomes effective, such modifications would be deemed "nonsubstantive" and not recognized for accounting purposes (thus, companies would not be able to accelerate compensation cost for deep underwater options by accelerating vesting).

Employee Stock Purchase Plans (ESPPs) – FAS 123r would not recognize compensation cost for ESPPs that are nondiscriminatory, incorporate no option features (such as a purchase price "look back" period), and provide for purchase discounts of 5 percent or less. If the above criteria are not satisfied, the ESPP would be deemed compensatory and compensation cost would be calculated using option valuation techniques.

Nonpublic Companies – FAS 123r would eliminate the "intrinsic value" alternative originally proposed by the FASB for equity awards and instead require that all nonpublic companies apply grant-date fair value methodology, unless it is not possible to calculate a reasonable fair value because of the inability to estimate expected volatility. In this situation, nonpublic companies would be instructed to calculate fair value using the historical volatility of an appropriate industry index (as opposed to a broad market index) as an input to the option-pricing model, and to disclose the index and how it was selected. Nonpublic companies would still be able to choose between intrinsic value and fair value for purposes of valuing liability awards.

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General questions about this letter can be addressed to Thomas M. Haines in our Chicago office at 312-332-0910 or by e-mail at tmhaines@fwcook.com. Copies of this letter and published materials are available on our website at www.fwcook.com under the following links:

Date	Title	Website Link
September 3, 2004	FASB Makes Progress on Stock Compensation Redeliberations	http://www.fwcook.com/alert_letters/9-3-04%20FASB%20Makes%20Progress%20On%20Stock%20Compensation%20Redeliber..pdf
July 22, 2004	Update on Close of FASB's Public Comment Period	http://www.fwcook.com/alert_letters/7-22-04-Update%20on%20Close%20of%20FASBs%20Public%20Comment%20Period.pdf
May 28, 2004	Lattice-Based Stock Option Valuation Models	http://www.fwcook.com/alert_letters/5-28-04%20Lattice-Based%20SO%20Valuation%20Models.pdf
April 13, 2004	FASB Issues Exposure Draft on Share-Based Payment	http://www.fwcook.com/alert_letters/4-13-04-FASB%20Issues%20Exposure%20Draft%20on%20Share-Based%20Payment.pdf.
February 26, 2004	IASB Issues Final Standard on Share-Based Payment	http://www.fwcook.com/alert_letters/2-26-04-IASB%20Issues%20Final%20Standard%20on%20Share-based%20Payment.pdf
November 5, 2003	FASB Announces Planned Effective Date and Method of Transition for Stock Option Expensing Mandate and Reaches Further Convergence with IASB	http://www.fwcook.com/alert_letters/11-5-03-FASB%20An%C9ing%20Mandate.pdf
September 18, 2003	FASB Delays Timetable on Stock Compensation Project but Project Derailment Still Not Likely	http://www.fwcook.com/alert_letters/9-18-03-FASB%20De&ion%20Project.pdf
August 8, 2003	Valuation of Employee Stock Options: Summary of Views from FASB's Option Valuation Group	http://www.fwcook.com/alert_letters/8-8-03ValuationEmployee.pdf
June 23, 2003	FASB Makes Headway on Stock Compensation Project	http://www.fwcook.com/alert_letters/6-24-03-FASB%20Makes%20Headway%20on%20Stock%20Compensation%20Project.pdf
March 14, 2003	FASB Decides to Add Stock Compensation Project to Agenda	http://www.fwcook.com/alert_letters/3-14-03-FASB%20to%20Add%20Stock%20Comp%20Project%20to%20Agenda.pdf
January 10, 2003	FASB Issues Final Standard on Amendments to Statement 123	http://www.fwcook.com/alert_letters/1-10-03-FASBIssuesFinalStandard.pdf
December 23, 2002	FASB Releases Invitation to Comment on IASB Share-Based Payment Exposure Draft	http://www.fwcook.com/alert_letters/12-02FASBReleaseInvitationTo%5B1%5D....pdf
October 11, 2002	FASB Releases Exposure Draft on Amendments to Statement 123	http://www.fwcook.com/alert_letters/10-11-02FASBReleasesExposure....pdf
March 20, 1996	Compliance with the Footnote Disclosure Requirements of FAS 123	http://www.fwcook.com/032096.html
November 8, 1995	FASB Releases Final Standard on Accounting for Stock-Based Compensation	http://www.fwcook.com/alert_letters/11895TMH.pdf