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SEC Staff Releases Guidance on Option Valuation Under Statement 123(R)

FASB Clarifies Post-Termination Option Exercise Provisions

The Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) have released additional guidance in regard to the new stock option expensing provisions of Statement 123(R) that are scheduled to become effective this July. While there have been recent press reports suggesting the SEC may be sympathetic to a further delay in Statement 123(R)'s effective date, neither the SEC nor the FASB to date have initiated steps to effect such a delay.

The SEC's guidance was released March 29 in the form of Staff Accounting Bulletin (SAB) No. 107, which provides extensive guidance for public companies in numerous areas, including the following:

- Companies can choose to use any valid option-pricing model (including the Black-Scholes-Merton model), can use different models for awards with different characteristics, and can infrequently change models
- Fair value estimates and assumptions made in good faith will not be subsequently challenged, no matter how significantly they differ from actual outcomes
- Additional guidance and safe harbors are provided in regard to estimating historical and implied volatility, and expected life
- Importance of MD&A disclosures in regard to equity compensation policies is emphasized, particularly during transition to the new rules
- Affirmation that it is permissible to accelerate vesting of stock options prior to effective date of new rules to avoid future expense, provided there is adequate disclosure of the modification and rationale

The FASB's guidance was posted March 31 in the form of proposed FASB Staff Position (FSP) EITF Issue 00-19-a, which provides relief for companies with liberal post-termination stock option exercise provisions, such as the ability to exercise vested stock options more than 90 days after specified terminations of employment. The guidance is somewhat cryptic, but appears to indicate that such provisions will not cause an otherwise fixed equity award to become a variable liability award, as was once feared.

The FASB is providing a 15-day public comment period until April 15, 2005, prior to issuing a final FSP. The guidance provided in SAB 107 is briefly summarized on the following pages.

Option-Pricing Models -- SAB 107 acknowledges that fair value estimates cannot predict actual future events and provides comfort to companies that, so long as the estimates are made in good faith, they will not be subsequently questioned no matter what the actual outcome. The SEC staff will not object to a company's choice of option-pricing model provided it meets Statement 123(R)'s three-pronged requirements that the valuation technique (1) is consistent with the fair value measurement objective, (2) is based on established principles of financial economic theory, and (3) reflects all substantive characteristics of the award. Further, it will be permissible to use different valuation techniques for awards with different characteristics, and to change valuation techniques without being considered a change in accounting principle (although the SEC staff does not expect companies to frequently switch between valuation techniques). Appropriate disclosure of any change in valuation technique should be made in financial statement footnotes.

Stock-Price Volatility -- SAB 107 provides extensive guidance on how companies should estimate expected volatility, particularly in regard to "historical" and "implied" volatility. In general, historical volatility should be measured on an unweighted basis over a period equal to or longer than the expected option term for closed-form models (such as Black-Scholes-Merton) or contractual option term for lattice models (such as binomial) based on daily, weekly, or monthly stock price observations. Future events should be considered to the extent other marketplace participants would likely consider them, and prior periods may be excluded in rare circumstances. Implied volatility is based on the market prices of a company's traded options or other financial instruments with option-like features, and is derived by entering the market price of the traded option into a closed-form model and solving for the volatility input. The SEC staff believes that companies with actively traded options or similar financial instruments generally should consider implied volatility, and even place greater or exclusive reliance on it, taking into consideration (1) volume of market activity, (2) synchronization of variables, and (3) similarity of exercise prices and option terms. SAB 107 also provides guidance for companies that wish to place exclusive reliance on either historical or implied volatility, and for newly public companies. Appropriate disclosure of the method used to estimate expected volatility should be made in the Management's Discussion and Analysis (MD&A) section of public filings.

Expected Option Term -- SAB 107 provides additional guidance for companies when estimating an option's expected term. In general, companies are not allowed to consider additional term reductions for nonhedgability, nontransferability, or forfeitures, and the option term cannot be shorter than the vesting period. Companies are permitted to use historical stock option exercise experience to estimate expected term (with as few as one or two relatively homogenous employee groupings) if it represents the best estimate of future exercise patterns. SAB 107 provides a simplified method to estimate expected term for "plain vanilla" stock options (as defined by SAB 107) that is calculated as the vesting period plus the original contractual option term divided by two. The SEC staff believes the simplified method should not be used for option grants after 2007, because more detailed information about employee exercise behavior should be widely available by then.

Enhanced MD&A Disclosure -- SAB 107 provides that companies should enhance MD&A disclosure related to equity compensation subsequent to adoption of Statement 123(R), and suggests discussion of the following:

- Transition method and effect on current and future financial statements, including cumulative adjustments

- Method used to account for equity compensation prior to adoption of Statement 123(R)
- Modifications to outstanding stock options made prior to effective date of Statement 123(R), including rationale for each modification
- Differences in valuation methodologies or assumptions (if any) compared to those used under Statement 123
- Changes in the quantity, type, or design of equity compensation programs, such as shifting from stock options to restricted stock or the introduction of a performance vesting condition

In addition, SAB 107 provides that companies should provide all disclosures required by Statement 123(R) in the first 10-Q filed after adoption of the new rules.

<u>*Other Guidance*</u> -- SAB 107 provides additional guidance in numerous other areas affecting equity compensation, including the following:

- So long as fair value estimates are prepared by a person with "requisite expertise," it is not a requirement that companies must hire an outside third party to assist in the valuation
- The guidance in Statement 123(R) as it applies to employees should generally be used by analogy for equity compensation granted to nonemployees
- When transitioning from nonpublic to public, stock options valued under the "calculated value" method (using stock price volatility of an appropriate industry index) prior to becoming public should continue to be valued under that method after becoming public, unless the stock options are subsequently modified, repurchased, or cancelled; in contrast, equity compensation liabilities valued under the "intrinsic value" method prior to becoming public should be valued at fair value subsequent to becoming public
- Companies can disclose the amount of non-cash equity compensation cost included in specific line items in financial statements, footnotes, or within MD&A
- Companies can disclose non-GAAP financial measures (such as net income excluding equity compensation cost) within MD&A, provided they are accompanied with appropriate descriptive disclosures, but pro forma presentations excluding equity compensation cost are prohibited
- When accounting for income tax effects of equity compensation, companies need only calculate additional paid-in capital available for offset if and when a tax deficiency occurs (that is, when tax return deductions are less than reported compensation cost)
- Companies can capitalize equity compensation costs through period end adjustments, rather than through their inventory costing system, without being considered a deficiency in internal controls
- Equity awards that are redeemable for cash at fair value at the holder's volition at least 6 months after share issuance should be classified outside of "permanent" equity (referred to as "temporary" equity)

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General questions about this letter may 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 other related materials are available on our website at www.fwcook.com under the following links:

Date	Title	Website Link
March 9, 2005	FAS 123(R) Requires Acceleration of Equity Compensation Cost for Retirement-Eligible Employees	http://www.fwcook.com/alert_letters/3-9-05-FAS%20123r%20Requires%20Acceleration%20of%20Equity%20Comp%20Cost%20..pdf
December 20, 2004	FASB Issues Final Statement on Accounting for Share-Based Payment	http://www.fwcook.com/alert_letters/12-20-04%20FASB%20Issues%20Final%20Statement%20on%20Accounting%20for%20Sha..pdf
October 20, 2004	FASB Decides on Effective Date for Option Expensing	http://www.fwcook.com/alert_letters/10-20-04%20FASB%20Decides%20on%20Effective%20Date%20for%20Option%20Expensing.pdf
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