

Frederic W. Cook & Co., Inc.

New York • Chicago • Los Angeles

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**REGULATORY UPDATE**

This letter briefly updates our readers on the status of several accounting and federal tax issues that could affect executive compensation.

**Stock Option Expensing**

As our readers are aware, the Financial Accounting Standards Board (FASB) earlier this year released an Exposure Draft (ED) that would require companies to expense stock options beginning in 2005 (2006 for nonpublic companies).<sup>1</sup> Since that time, the FASB has received and reviewed thousands of public comment letters and held one day of roundtable meetings on each coast. The FASB on August 4 began a heavy schedule of redeliberations that is expected to culminate this fall with the release of a final standard before year end. The final rules are expected to be substantively similar to the ED, with compensation cost to be recognized net-of-tax over the requisite service/vesting period based on modified grant date fair value methodology, with binomial lattice-based models preferred over the closed form Black-Scholes formula. However, there could be some changes to the ED based on public feedback (such as more guidance on estimating fair value, and reconsideration of rules dealing with income tax effects, graded vesting schedules, nonpublic and small companies, and retrospective application), *and it is possible that there could be a delay in the proposed 2005 effective date.* The FASB plans to address the proposed effective date towards the end of its redeliberation process, after it has settled all other substantive issues.

**Earnings Per Share**

The FASB also is nearing completion of a convergence project with the International Accounting Standards Board (IASB) that would (among other changes) subtly affect how equity compensation could dilute earnings per share (EPS). The proposed changes would redefine the stock price that must be used when making “treasury stock method” computations for quarterly and year-to-date reports, changing from “weighted-average” to “average” stock price for the period. The proposed changes would also no longer permit companies to assume that outstanding stock-based awards will be settled in cash (and therefore not dilute EPS) rather than in stock for awards that may be settled in either cash or stock, notwithstanding past experience or

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<sup>1</sup> Refer to our letter dated April 13, 2004 for a detailed summary of the ED.

a stated policy of cash settlement.<sup>2</sup> The proposed effective date (which is not yet final) would be for interim and annual periods *ending* after December 15, 2004, with retrospective restatement of prior periods.

Companies which use diluted EPS as a performance measure in their annual and longer-term incentive plans should estimate the effect this change, if enacted, would have on their 2004 and prior years' EPS, and they should identify ways to avoid any compensation windfalls or shortfalls this change would have on incentive periods currently underway.

### **Deferred Compensation**

Prior to adjourning for its August recess, the House and Senate approved separate versions of legislation that, if it becomes law, would make vested nonqualified deferred compensation taxable on a current basis unless certain restrictive requirements are met. As currently drafted, the proposed legislation could affect (in addition to traditional voluntary nonqualified deferred compensation arrangements) stock appreciation rights (SARs), deferred stock units, ERISA excess plans, and supplemental executive retirement plans (SERPs), and could impose more stringent restrictions on initial deferral elections, subsequent redemptions, investment alternatives, account distributions (including accelerated distributions with "haircuts"), and the ability to defer equity gains (such as option exercise profits).<sup>3</sup> The deferred compensation provisions are part of a much larger bill dealing with export tax repeal and tobacco buyout, and it remains uncertain whether Congress will be able to pass a bill between Labor Day and the November elections.

### **Incentive Stock Options**

Last, the Internal Revenue Service (IRS) on August 2, 2004 issued final regulations in regard to incentive stock options (ISOs) that provide only minor revisions to the proposed regulations issued last year, with one notable exception for stock plan professionals.<sup>4</sup> The proposed regulations would have deviated from past practice by requiring ISO plan documents to stipulate a maximum share limit for each specific grant type authorized under the plan (such as nonqualified stock options, restricted stock, etc.), not just for ISOs. The final regulations make clear that a maximum share limit need only be specified for ISOs, consistent with current practice. This is a favorable outcome for ISOs, as many stock plan professionals would have simply excluded them from plan documents to preserve flexibility. However, it is expected that ISO usage will nevertheless decline in an option-expensing environment due to the financial inefficiency of the forgone company tax deduction.

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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 email at [tmhaines@fwcook.com](mailto:tmhaines@fwcook.com). Copies of this letter and other related letters on this topic are available on our website, [www.fwcook.com](http://www.fwcook.com).

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<sup>2</sup> Refer to our letters dated April 24, 1996 and March 17, 1997 for a detailed summary of the calculation of EPS and the treasury stock method.

<sup>3</sup> Refer to our letters dated May 29 and June 28, 2004 for a detailed summary of the proposed legislation.

<sup>4</sup> Refer to our letter dated July 16, 2003 for a detailed summary of the proposed ISO regulations.