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September 3, 2004

FASB Makes Progress
On Stock Compensation Redeliberations
Delay in Effective Date May Not Be Necessary

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). Credible sources have speculated that the 2005 effective date may be delayed. However, over the past month, the FASB has made significant progress in resolving issues raised during the comment period and roundtable discussions, which could keep the FASB on its original track. The FASB's most significant tentative decisions to date are:

1. Eliminating preference for lattice-based models
2. Retaining ability to use straight-line cost amortization for awards with graded vesting
3. Permitting retrospective restatement of financial statements
4. Retaining current accounting treatment for income tax effects
5. Permitting minimal purchase discounts for Employee Stock Purchase Plans (ESPPs)

The FASB's tentative conclusions on these and other issues are discussed below. The FASB plans to address the effective date issue towards the end of its redeliberation process (which is expected to be within the next month) and issue a final standard in the fourth quarter of this year.

A key premise for the entire ED, which has been reaffirmed by the FASB, is that companies should recognize an expense in the income statement for employee services received in exchange for share-based payment. This expense should be measured using the grant-date fair value of the equity being issued, and should be measured over the "requisite service period," which is the vesting period for service-vesting awards. Also reaffirmed is that awards settled in shares should be classified as equity, not as liabilities.

Lattice-Based Models

The final standard would no longer specify a preference for a lattice model (e.g., binomial), as opposed to a closed-form model (e.g., Black-Scholes), for valuing equity awards. This critical decision should make compliance with the new rules more feasible for many companies and minimize the need for a delayed effective date.

Graded-Vesting Awards

For awards with graded vesting, such as pro-rata or installment vesting, the FASB decided to revert to FASB Statement No. 123's (FAS 123) original rules that mandate accelerated accruals only if a company uses tranche-specific expected lives to value the awards. Otherwise, companies would have a choice between straight-line and accelerated accruals for awards with graded vesting.

Modified Retroactive Restatement

A form of retrospective application of the rules would be allowed. That is, for prior financial periods, companies would be allowed to move the pro forma FAS 123 cost of equity-based compensation from the footnotes to the financial statements themselves.

Income Tax Effects

The FASB again reverted to 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. 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, and then the remainder would be recognized as increased income tax expense on the income statement. On the cash-flow statement, excess tax benefits would be reported as a financing cash inflow.

Employee Stock Purchase Plans (ESPPs)

The FASB decided that ESPPs would not incur compensation cost if:

1. The terms of the ESPP are no more favorable than those available to all shareholders ***or*** the discount does not exceed the company's cost of offering shares through an underwriter,
2. The plan is broad-based, ***and***
3. The ESPP has no option features, such as look-backs.

Assuming the underwriting cost of a stock offering is approximately 5 percent, this decision essentially has the effect of retaining the exception currently available under FAS 123 for broad-based ESPPs that provide discounts of 5 percent or less. However, companies that choose to maintain typical ESPPs (15 percent discount and six-month look-back period) would incur an expense under the new rules.

Other Issues

Reload Stock Options – For options with a reload feature, the FASB maintained its position that instead of incorporating the value of the reload feature into the original stock option, each reload would be treated as a new separate grant and expensed accordingly.

Market Conditions vs. Performance and Service Conditions - The FASB maintained its position that awards that vest based on a "market condition," such as specified share price, level of total shareholder return, or total shareholder return relative to an index or peer group, would be valued at the time of grant, with no adjustment made to compensation cost regardless of whether or not the market condition is satisfied. Presumably the value of an award with a market condition would be lower than the value of an award without such a condition. The FASB believes that models exist to estimate the fair value of an award with a market condition at the time of grant, and therefore, no subsequent adjustment is required even if the market condition performance criteria are not satisfied.

For awards with a “performance condition” not related to the company’s relative or absolute share price or shareholder return, or a “service condition” (i.e., time-based vesting), the per share fair value of the award would be estimated at the time of grant without consideration of the effect of the performance or service conditions, and the expense would be “trued-up” based on the actual number of shares that vest or are earned. In other words, “price” would be fixed at grant, but “quantity” would not. The FASB believes that the performance and service conditions cannot be accurately reflected in fair value at grant using current models.

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General questions about this letter can be addressed to Thomas M. Haines or Cimi B. Silverberg in our Chicago office at 312-332-0910 or by e-mail at tmhaines@fwcook.com or cbsilverberg@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
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