March 20, 1996

Compliance With The Footnote Disclosure Requirements Of FAS 123

Introduction

This letter is intended to provide preliminary guidance to compensation professionals as they begin to comply with complex new footnote disclosures required by the new accounting standard for stock-based compensation (FAS 123).[1] As the current annual report season enters full swing, it is important to remember that the disclosure requirements of FAS 123 are generally effective for 1996 financial statements, and thus will be reported during next year's annual report season. The following discussion is directed toward calendar year companies that continue to account for their employee and nonemployee director stock-based awards under the provisions of Accounting Principles Board Opinion No. 25 (APB 25).

Why the Urgency?

Companies remaining under the provisions of APB 25 are required by the new disclosure rules to compute and disclose compensation cost for their stock-based awards under the complex provisions of FAS 123. The potential dilution to net income and earnings per share resulting from such ongoing calculations is expected to vary significantly among companies, ranging from 2 percent for typical "blue-chip" companies with aggregate annualized stock option grants of 1 percent of total shares outstanding to upwards of 20 percent for "high-growth" companies with aggregate annualized grants exceeding 3 percent. Thus, it is reasonable to assume that Board Compensation Committees and other interested parties will be interested in reviewing drafts of the new footnote disclosures well in advance of the next year's annual report season.

What About Materiality?

As with all accounting standards, the new footnote disclosure provisions of FAS 123 are required only for "material items." While there is no "bright-line" test for determining materiality, it is reasonable to assume that many companies will consider the effects of FAS 123 to be immaterial and thus avoid some or all of the required disclosures. Unfortunately, however, companies must still perform "ball park" calculations to determine whether the disclosures of FAS 123 are in fact immaterial.

What Are The New Disclosure Rules And When Are They Effective?

The disclosure provisions of FAS 123 consist of "general disclosures" which are applicable to all companies, plus "pro forma" disclosures which apply only to companies remaining under the rules of APB 25. The general disclosure rules are effective on a *prospective* basis beginning with 1996 financial statements, although companies may provide the required information for any previous year for which an income statement is provided. The pro forma disclosure provisions

[1] Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation; see our letter dated November 8, 1995.

are also first required for 1996 financial statements, but are effective on a *retroactive* basis to include 1995 grant activity. In addition, beginning with *1995* financial statements, companies should identify and describe whether they account for employee stock-based awards under the provisions of FAS 123 or APB 25. The 1996 financial statements for a typical calendar year company will therefore include: (1) an identification of whether FAS 123 or APB 25 is used to account for stock-based awards, (2) general disclosures for *at least* 1996 award activity, and (3) pro forma disclosures for 1995 *and* 1996 activity.

What Are The General Disclosure Rules?

The general disclosures require a description of stock-based compensation plan and award terms, such as the number of shares authorized, the maximum option term, and the vesting requirements. The general disclosures also require the following specific information with respect to stock option and other stock-based award activity for each year for which an income statement is provided, beginning with 1996 financial statements:

Calendar Year 1996			
	Stock Options		Other Stock-Based Awards (000)
	Shares (000)	Weighted-Average Exercise Price	
• Outstanding at beginning of year			NR
• Granted			
• Exercised			NA
• Forfeited			NR
• Expired			NR
• Outstanding at end of year			NR
• Options exercisable at end of year			NA
• Weighted-average “fair value” of awards granted during the year • Range of exercise prices and weighted-average remaining contractual life of options outstanding at end of year			
• Methodology and assumptions used to calculate “fair value” • Total compensation cost recognized in the income statement (under APB 25) • Significant modifications to outstanding awards			

NA Not Applicable; NR Not Required, but companies may wish to *voluntarily* present this information

If the range of exercise prices of stock options outstanding at the end of the most recent year varies by more than 150 percent, companies are instructed to stratify the outstanding options into meaningful ranges and provide the following information for each range:

Calendar Year 1996					
	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
(if varies by more than 150 percent)					

Companies are also instructed to segregate the above information by award type to the extent it would provide more meaningful information to financial statement readers. For example, a

company which grants “performance-vesting” or “reload” stock options in addition to “normal” stock options should provide the general disclosures separately for each grant type.

What Are The Pro Forma Disclosure Rules?

The pro forma disclosures, which should prove to be the most difficult to comply with, require APB 25 companies to reveal what net income and earnings per share *would have been* had the company accounted for its stock-based awards under the provisions of FAS 123. Calendar year taxpayers are required to disclose the following information for 1996 financial statements, with a caveat that the pro forma amounts may not be representative of future years to the extent there are outstanding unvested awards granted prior to 1995:

		1996	1995
Net income:	As reported		
	Pro forma		
Primary earnings per share:	As reported		
	Pro forma		
Fully diluted earnings per share:	As reported		
	Pro forma		

Although the general disclosure rules require all companies to compute the “fair value” of awards granted during the year, the pro forma disclosures further require APB 25 companies to recalculate compensation cost for all awards granted after 1994 using the special valuation provisions of FAS 123, including provisions with respect to vesting, forfeitures, modifications, settlements, and broad-based stock purchase plans.

How Is Compensation Cost Calculated?

In general, compensation cost under FAS 123 is equal to a stock-based award’s “fair value” at grant, less the amount (if any) paid by the award recipient. Compensation cost is generally recognized ratably over the award’s vesting period, except for certain stock options with pro rata vesting schedules (as opposed to “cliff” vesting schedules) which may be subject to an accelerated accrual methodology. Compensation cost is generally *not* recognized for stock-based awards which do not vest, unless the forfeiture is due to the expiration of unexercised vested stock options or the failure to satisfy certain “stock price” or “intrinsic value” performance conditions. Lastly, compensation cost is generally recognized “net-of-tax” for stock-based awards which normally give rise to tax deductions (such as nonqualified stock options), but is not tax affected for awards which normally are not tax deductible (such as incentive stock options or tax-qualified employee stock purchase plans).

Fair value for stock options is calculated using a Black-Scholes or binomial pricing model, and fair value for other stock-based awards is generally calculated at the fair market value of the underlying stock at grant. Fair value for stock-based awards which require cash settlement is equal to the amount of cash paid, with interim accruals based on changes in stock price between grant date and payment date. Fair value may *not* be reduced by subjective discounts or “haircuts” which are intended to account for transferability and forfeiture restrictions common with employee stock-based awards.

While all stock-based awards must be revalued under the new provisions of FAS 123, the most significant difference between reported and pro forma net income and earnings per share is expected to come from stock options and broad-based stock purchase awards, because most companies do not currently recognize compensation cost for these awards under APB 25.

How Is Compensation Cost Calculated for Stock Options?

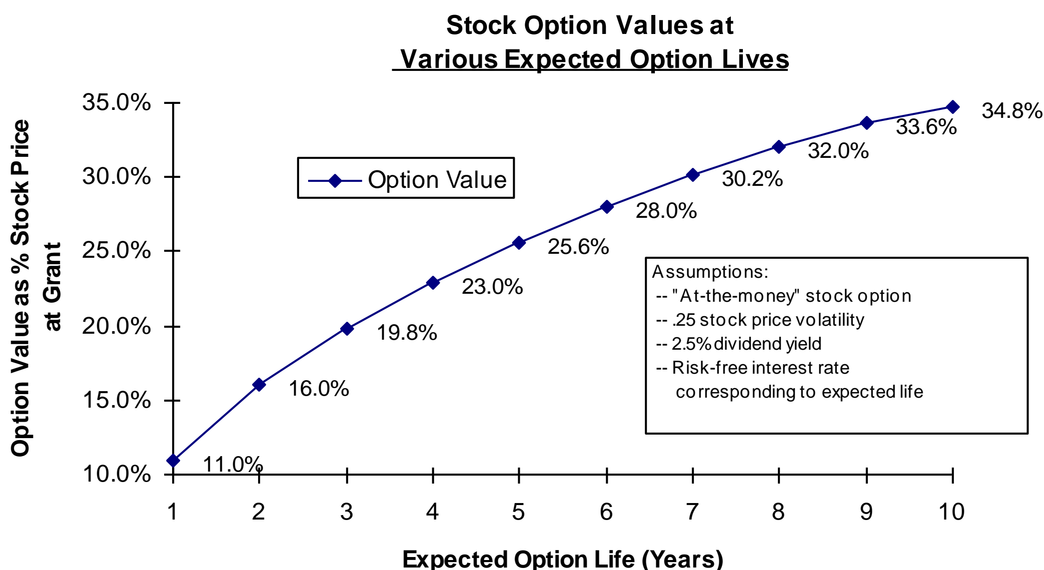
Compensation cost for stock options and stock appreciation rights (SARs) payable in stock is calculated using a Black-Scholes or binomial pricing model that takes into account at grant the following six variables:

1. Fair market value of stock
2. Exercise price of option
3. Risk-free interest rate
4. Expected life of option
5. Expected stock price volatility
6. Expected dividends on stock

The first three variables are not difficult to determine because stock price at grant and exercise price are "given," and the risk-free interest rate must approximate the yield of zero-coupon U.S. Treasury "Strips" with a remaining term equal to the expected life of the option. The last three variables require considerable judgment, however, and may be very difficult to determine. The company's objective should be to use estimates which result in the lowest "reasonable" option value, while considering both practicality and materiality. A company's estimates should be considered "reasonable" if they could pass a third-party "smell test" based on information available at grant and expectations about the future. Further, FAS 123 permits companies to use "low end of a range" estimates for expected life of the option and stock price volatility, and "high end" estimates for expected dividends.

How Is The Lowest Reasonable Cost Calculated?

The most important variable to derive is the "expected life of the option," because the volatility, dividend, and risk-free interest rate assumptions are generally dependent on the expected life. Companies should strive to derive the lowest expected life possible because, all other variables held constant, a lower expected life results in a lower fair value. The following chart illustrates how the fair value of a stock option varies using different expected life assumptions:



The problem, however, is that demographic data on employee exercise behavior may be difficult to obtain. For example, how does a company derive an expected option life if a large percentage of the options granted in recent years are still outstanding? We believe a reasonable approach would be to stratify stock option grants over the last several years into one or more employee groups and/or grant variations to see if there are any significant variations in option life. Examples of such stratifications could include executive versus nonexecutive employees, U.S. versus international employees, and "service-vesting" versus "performance-vesting" versus "reload" stock options. Regardless of which stratification methodology is used (if any), the average option life derived from previous grants should be weighted so as to place less emphasis on grants with a large percentage of unexercised options outstanding and more emphasis on grants with few or no unexercised options outstanding.

Companies may be so specific in their stratification methodology that they are able to estimate an expected life for each "tranche" of an option with a pro rata vesting schedule. To do so, however, subjects the company to a more complex and accelerated accrual schedule for recognizing compensation cost. Also, FAS 123 suggests that companies may be able to "indirectly" estimate expected life through a complex manipulation of an option pricing model using an assumed future stock price at which options would be expected to be exercised.

Once the expected life assumption is determined, the stock price volatility and dividend variables are readily calculated using a computer spreadsheet. Companies should calculate several estimates of these variables using different time periods, stock prices, and weighting schemes. Companies should use estimates for these variables which result in the lowest reasonable option value.

What About Stock Options With Design Variations?

FAS 123 prescribes special rules for the following stock option design variations:

Premium or Discount Options -- Fair value for stock options with exercise prices above or below the market price at grant are simply valued by using the appropriate "premium" or "discount" exercise price assumptions, even though the option pricing model often produces anomalous results. In some instances for example, the fair value calculated for a discount stock option is *less* than the discount which exists at grant.

Performance-Vesting Options -- Many companies grant stock options with vesting based solely on, or accelerated by, the attainment of specified stock price goals. Although companies are not permitted to reduce compensation cost for forfeitures resulting solely from such contingencies, FAS 123 suggests that companies may *reduce* the fair value calculated for such "path-dependent" options by making complex modifications to the option pricing model.

Option With Dividends -- Fair value for dividend-paying stock options is simply calculated using a dividend input of zero.

Reload Stock Options -- Fair value is calculated for "reload" stock options in the same manner as normal stock options. However, options with a reload feature (as well as the reload option itself) may have a significantly lower expected life than a normal option because reloads are designed to encourage the early exercise of stock options.

What About Employee Stock Purchase Plans?

The above guidance for stock options also generally applies to broad-based employee stock purchase plans which incorporate "option" features or purchase discounts in excess of 5 percent. For purchase plans with relatively short purchase periods (e.g., 1 year or less), compensation cost should range from 0 to 10 percentage points above the purchase discount. As with normal stock options, however, compensation cost for stock purchase awards increases (over and above the purchase discount) as the expected purchase period increases. For stock purchase plans with a purchase price equal to the "lesser of" stock price at the beginning or end of the purchase period, compensation cost is calculated under a complex methodology which assumes the award is composed of (1) a non-dividend-paying share of stock equal in value to the purchase discount, and (2) an at-the-money stock option equal in value to the discounted purchase price. The effect of the methodology is to ascribe a higher value to such "look-back" awards than would be derived if the awards were simply valued as discount stock options.

How is Compensation Cost Calculated For Other Stock-Based Awards?

The calculation of compensation cost for other stock-based awards such as performance shares or restricted stock depends on whether the awards are to be settled in stock or cash. For awards that are to be paid in stock, compensation cost is generally equal to the fair market value of the underlying stock on the date of grant. Unlike APB 25, the treatment applies equally to awards with service- or performance-based vesting requirements. Thus, while restricted stock awards should *not* result in differences between reported and pro forma net income and earnings per share, performance share awards would result in *favorable* adjustments to pro forma amounts if the company's stock price increases during the performance period.

Dividends (if any) paid during the vesting period are not recognized as additional compensation cost, unless the underlying awards are subsequently forfeited. Compensation cost for non-dividend-paying awards is reduced by the present value of estimated forgone dividends over the vesting period.

For stock-based awards that call for cash settlement, compensation cost is calculated in the same variable mark-to-market fashion as currently exists under APB 25. Thus, awards of this type should *not* result in differences between reported and pro forma net income and earnings per share.

General questions may be addressed to Thomas Haines at 312-332-0910. Specific questions should be addressed to the company's professional accountants.