

STOCK OPTION EXPENSING: CHANGES YOU NEED TO KNOW

Is your company expensing stock options correctly? Stock option expensing is a "hot" issue and has become a more urgent issue now that your company will be required to expense all employee stock options at "fair value." Absent intervention by Congress or changes to the FASB's current proposal, which are both unlikely, your company will need to start expensing options at fair value in fiscal years beginning after December 15, 2004 (for public companies) or in fiscal years beginning after December 15, 2005 (for nonpublic companies).

For decades now, accounting rules and the SEC (by administrative fiat) have required companies to expense all employee compensation. Compensation is expensed because it is a cost of doing business. Prior to the current FASB proposal, there were two alternatives for expensing employee stock options.

The first method, the intrinsic value method, allowed companies an end run around the expensing requirement. Essentially, because of the way that an option was valued, when a company used the intrinsic value method, it avoided expensing options and reported a higher net income. The "intrinsic value" of an option is the excess of the market price on the grant date over the price at which the option is given. In layman's terms, if a company gave a fixed number of options at market price on the grant date, then the option would have no intrinsic value (grant date market price - option price = expense) and thus require no expensing. In addition to an end run around expensing, there is a disproportionate tax benefit with the intrinsic value method. When an employee exercised the option, the company could deduct the difference between exercise price and the option price. This method had two benefits for companies: 1) net income could be increased by expensing options with no intrinsic value and 2) the company received a tax benefit when the employee exercised the option.

In 1995, the FASB began encouraging companies to use a different method of valuation: the "fair value" method. Fair value is determined using a complicated option pricing model (e.g. Black-Scholes or a binomial pricing model) that accounts for many factors including: grant date, exercise price, expected life of the option, current price of the stock, expected volatility, expected dividends, and interest rate over the life of the option. Using the pricing model, the "fair value" of the option is measured at the grant date, and the company expenses a portion of this amount annually over the vesting period of the option. While the use of the fair value was encouraged, companies were not required to adopt this method. In fact, companies could use the old intrinsic value method by merely making pro forma disclosures of net income and basic and diluted earnings per share. Until now, companies could chose how to value and expense options.

Under the new rules, companies can no longer use the intrinsic value alternative. Companies will still be required to expense stock options, but now they must use the fair value method. The FASB believes that these changes will: 1) decrease the financial statement distortion that occurs with the intrinsic value method, 2) assist investors in comparing companies, and 3) align U.S. accounting standards with international accounting standards.

We expect the expensing/valuation changes to affect many of our clients. Fortunately, the FASB has offered respite to nonpublic companies. Although the SEC requires public companies to use FASB standards, the SEC does not require nonpublic companies to use those standards; however, many private companies must use them due to lending or other business/contractual obligations. Nonpublic companies using FASB standards will benefit from several provisions to alleviate the cost of implementing these changes. The most important provision allows nonpublic companies to continue using the less expensive intrinsic value method. However, the old intrinsic value method has been modified somewhat. Now, even using intrinsic value, nonpublic companies must expense the options periodically over the vesting period. More importantly, companies must expense the difference between the intrinsic value at a report date and the grant date intrinsic value.

While the FASB's changes may seem small, these changes have the potential to heavily impact income, depending upon how many options your company issues. Since these changes are becoming final at the end of the year, now is a good time to examine how your company is expensing stock options. Should you have any questions about this or other employment or benefit issues, please contact any of the attorneys below.

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