

Alert

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Expensing/Valuing of Stock Options to be Required for Public and Private Companies in 2005

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In an effort to ease the burden for companies bogged down with Sarbanes-Oxley, the FASB has decided to delay implementation of *Share-Based Payment, an Amendment of FASB Statements No. 123 and 95*, the exposure draft it issued in March. Implementation will take effect for public companies on Jun. 15, 2005, while private companies have been given until Dec. 15, 2005, to start expensing options. Although companies have been given a stay of execution, the FASB has completed redeliberation and plans to issue the final statement by the end of the year. In its final redeliberation meeting, the Board made some significant decisions that will impact nonpublic entities.

INTRINSIC VALUE METHOD

Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, requires that all share-based payment be measured at fair value. Statement 123 also provided an alternative to use Opinion 25's intrinsic value method of accounting. Intrinsic value, as defined in the exposure draft, exists if the market price of the share exceeds the exercise price. Most employee stock option plans are structured so that the exercise price equals the quoted market price on the grant date. As a result, the option has no intrinsic value on the grant date and the compensation cost is equal to zero.

During the redeliberation process, the FASB addressed concerns from respondents to the proposed statement. More than half of the respondents were opposed to nonpublic companies being allowed to use the intrinsic value method as an alternative method for measuring share-based compensation.

Respondents held three main views against allowing the intrinsic value method:

- 1) A company's decision to use the intrinsic value method is inconsistent because similar transactions should be accounted for using a similar accounting method.
- 2) Application of the intrinsic value method is inconsistent with the grant-date approach.
- 3) The intrinsic value method has operational difficulties because it would require remeasurement each reporting period, compared to the fair value method which would require a single valuation.

The Board decided that nonpublic companies would be required to use the fair value method it proposed in the exposure draft unless one of the following scenarios exists:

- 1) The nonpublic entity is unable to make a reasonable estimate of the expected volatility of its own stock price. In this situation, a nonpublic entity would use the

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VRC NEWS

VRC will be presenting a webcast, "The Importance of Pre-Acquisition Valuations," on January 11, 2005 at 1:00 CT. Register at www.valuationresearch.com/registration.htm.

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historical volatility of an appropriate index, rather than using the expected volatility of its own stock price, as an input in the valuation model. A nonpublic entity that uses this approach would be required to disclose the index selected and how it made this selection.

2) The nonpublic entity cannot reasonably estimate fair value because the unusual features of a particular equity award prevent it from doing so. In this case, a nonpublic entity would be required to apply the intrinsic value method as described in the final statement.

“The FASB's ultimate goal is to align U.S. accounting standards for share-based compensation with International Accounting Standards Board (IASB) standards.”

VALUATION METHODS

In the absence of observable market prices, the FASB requires use of an option-pricing model to value employee stock options. The Board maintained during redeliberations that either a closed-form, (Black-Scholes) model, or a lattice (binomial) model should be used to value employee stock options. The Black-Scholes model, intended for publicly traded options, fails to accurately value employee stock options since it does not take into account the option's lack of marketability. To account for this lack of marketability, the FASB has supported the use of an expected term for the option based on historical exercise behavior in the employee population, rather than the application of an appropriate discount for illiquidity based on the specifics of the option plan.

A lattice model considers an employee's expected exercise and post-vesting employment termination behavior. This type of model can incorporate a term structure of volatility, and can also accommodate differences in exercise behavior across the employee population. The lattice model can be difficult to implement if sufficient historical data on an employee's exercise behavior is not available.

In its original proposal, the FASB had stated a preference for a lattice model. Recognizing that one option-pricing model may not be appropriate for all circumstances, the FASB has indicated that it would not be identifying a preferred model in the final statement. Additionally, the Board will not be prescribing a single method for estimating volatility. The Board states that, "an entity should make a reasonable and supportable estimate of expected volatility that is consistent with the stated fair value objective." The final statement will include guidance on the process a company might follow in estimating volatility.

The FASB's ultimate goal is to align U.S. accounting standards for share-based compensation with International Accounting Standards Board (IASB) standards. The IASB's rule for expensing options, similar to the U.S. standard, will be effective January 1. For more information regarding valuing stock options, contact your Valuation Research representative or Larry Van Kirk at (513) 579-9100. **VR**

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