

SEC DELAYS IMPLEMENTATION OF MANDATORY EXPENSING OF OPTIONS

The Securities and Exchange Commission (SEC) has delayed the compliance dates for the accounting statement that requires the expensing of employee stock options. Under the SEC's revised compliance dates, most public companies will be required to comply with the statement, the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (Statement 123R), in the first quarter of their first fiscal year beginning after June 15, 2005.

Revised Compliance Dates

The FASB adopted Statement 123R in December 2004. As initially adopted, public companies were generally required to adopt Statement 123R in their first interim or annual reporting period beginning after June 15, 2005. Accordingly, companies could have been required to adopt Statement 123R in the middle of their fiscal year. Under the SEC's revised compliance schedule, however, public companies are not required to adopt Statement 123R until their next fiscal year that begins after June 15, 2005 (specifically, Statement 123R would be required to be adopted for the first interim or annual reporting period in that fiscal year). For calendar year-end companies, the delay means that adoption of Statement 123R will be required in the first quarter of fiscal 2006 rather than the third quarter of fiscal 2005. Small business issuers are required to adopt Statement 123R in the first interim or annual reporting period of their first fiscal year beginning after December 15, 2005. Companies are encouraged, but not required, to comply with Statement 123R before the mandated compliance date.

Statement 123R, as adopted by FASB, requires nonpublic companies to comply as of the beginning of the first reporting period that begins after December 15, 2005. The delay adopted by the SEC does not affect this compliance schedule.

The SEC, in its release adopting the delay, stated that, as a result of feedback from public companies, industry groups, and public accounting firms, it was concerned that initial implementation of Statement 123R in a period other than the first quarter of a fiscal year could make compliance complicated, since public companies would be required to change their accounting systems in the middle of their fiscal year. Consequently, auditors' audit, review, and attest procedures would be less consistent within a single fiscal year. In addition, because companies are not required to restate prior financial results upon adoption of Statement 123R, adoption of Statement 123R in the middle of a fiscal year may make comparisons with prior periods more difficult for investors.

Statement 123R

Statement 123R requires companies to recognize the cost of employee services received in exchange for stock options based on the fair value of those options as of their grant date (the *fair value* method of determining the expense associated with the options). Such cost is to be recognized over the period during which an employee is required to provide services in exchange for the award (usually the vesting period). Statement 123R supersedes a previous FASB statement addressing the accounting for stock options. Under the previous FASB statement, companies were required to expense equity-based employee compensation, such as stock options, but were permitted to use either of two methods – the fair value method or the *intrinsic value* method – to determine the value of the compensation to be expensed. Under the intrinsic value method, which a company will no longer be permitted to use after it adopts Statement 123R, options issued with an exercise price equal to the fair market value of the underlying stock at the date of grant would not require the issuing company to recognize any compensation expense.

Statement 123R applies to awards granted, modified, repurchased, or canceled after the required effective date.

The FASB stated that requiring recognition of compensation costs based on the fair value method will help users of financial statements better understand the amount of employee services paid for through equity instruments such as stock options. By requiring the recognition of the cost of such services, the financial statements should better reflect their economic effect. In addition, by eliminating the ability to account for similar transactions by different methods, the FASB hoped to simplify generally accepted accounting principles and improve the comparability of companies' financial statements. The changes made by Statement 123R are similar to recent changes in international accounting standards.

Under Statement 123R, companies will also be required to estimate the number of options for which the requisite service is expected to be rendered (*i.e.*, they must continue to estimate the number of options that will be forfeited). Previously, companies could account for forfeitures as they occurred. This means that performance-based vested awards, which would no longer be treated as variable awards, will have their compensation cost measured at the grant date with adjustments made each period based on a current estimate of the number of options that will vest.

Certain employee stock purchase plans will also be required to be expensed under Statement 123R. After adopting Statement 123R, a company will be required to recognize compensation costs associated with such a plan unless the plan satisfies certain conditions, including that there be no more than a 5 percent discount on the stock purchased and that the purchase price be based on the fair market value on the purchase date (that is, there be no "look-back" feature). Any compensation expense required to be recognized with respect to an employee stock purchase plan would be based on the amount of the discount and the fair value of any look-back.

Statement 123R requires nonpublic companies to measure the cost of employee services paid for through equity awards by use of the fair value method. However, the statement provides that if it is not possible to estimate the fair value of stock options because it is not practicable to measure the volatility of the issuing company's share price, a nonpublic company may use a measure of volatility based on the historic volatility of an appropriate industry sector.

Statement 123R clarified accounting for awards classified as liabilities rather than equity instruments. These are instruments, such as stock appreciation rights, that require settlement by transfer of cash or other assets. Like equity instruments, a public company would be required to recognize the cost of the services received in exchange for the award by measuring the fair value of the instrument. However, such companies would be required to record changes in such fair value at each reporting date throughout the period during which the employee is required to provide service in exchange for the award.

Another change under Statement 123R is that companies must account for incremental compensation cost of a modification of the terms of an option by comparing the fair value of the modified option with the fair value of the option immediately before the modification. This incremental cost would be recognized over the remaining vesting period. Statement 123R also clarifies guidance on methods of measuring fair value, including which valuation models should be used, such as the Block-Scholes formula or a binomial model.

Implications

Expensing of options has been on the horizon for some time now, and the delay adopted by the SEC pushes it off by another six months for most calendar year-end public companies. Companies that have not done so already – especially companies that make heavy use of employee stock options and similar compensation strategies – may want to use the additional period before compliance is required to assess how Statement 123R affects them.

Financial and accounting personnel should be ready to comply with the new requirements. The rules will require the use of assumptions and estimates regarding future events, and the use of possibly complicated valuation models. These items are likely to be different than those required for use in financial statement footnotes under the previous requirements.

As part of their assessment, companies should also review the types of equity compensation they award and whether alternative types of compensation will be more advantageous under Statement 123R. For example, companies may wish to reduce the fair value of the options they grant by reducing the term of the options. Also, performance-based vesting awards will likely be more attractive, due to the elimination of variable accounting. Companies should ensure that their equity compensation plans are sufficiently flexible to grant any desired alternative forms of compensation.

Finally, companies may want to review whether their employee stock purchase plans remain advantageous if costs are required to be expenses. Alternatively, companies could review modifying their plan to meet the conditions necessary to avoid expensing.

For Further Information

If you have any questions about the information in this Alert, please contact one of the members of the Duane Morris Securities Practice Group listed below or the lawyer in the firm with whom you are regularly in contact.

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