

Current Trends in Equity Compensation

CEP Symposium – September 2004

Presented by
Ellie Kehmeier and Jill Hemphill

Current Trends in Equity-Based Compensation

Agenda

- Summary of Proposed New Accounting Rules
- Emerging Practice
 - Key Themes
 - Alternative Approaches
- Tax Issues
 - Nonqualified Deferred Compensation Legislation
 - IRS Executive Compensation Audit Initiative
 - New ISO Regulations

FASB's New Project on Equity-Based Compensation

Background

- Timing of the project:
 - March 2004: Exposure draft released
 - Second/third quarter of 2004: Comment period, public roundtables, and re-deliberations (taking place now)
 - Fourth quarter of 2004: Final standard expected
 - Effective date: Fiscal years beginning after 12/15/04, but there is some support for delay
 - Stay tuned

Legislative Update

- On July 20, The House passed H.R. 3574, Stock Options Accounting Reform Act, by a vote of 312 to 111
- A companion bill in the Senate, S. 1890 is pending in the Senate Banking, Housing and Urban Affairs Committee
- If passed, this bill would
 - Require expensing for grants to top 5 highest paid execs
 - Zero volatility to be assumed
 - Exemption for newly public companies (first three years) and companies with revenues < \$25M
 - Prohibit SEC from recognizing any standard without a “true-up” provision, based on actual spread at exercise

Reaction to House Passage of HR 3574

Supporters

- Senator Barbara Boxer, quoted in the San Jose Mercury News on 7/21/04, says she believes a majority in the Senate support the bill:
 - "The vote in the House is a beautiful thing for us because it shows the bipartisanship, it shows the strong support that this has."
- From BNA, 7/21/04, quoting Jeff Peck, a lobbyist for the International Employee Stock Options Coalition:
 - "This is an incredibly powerful and compelling statement to FASB and the SEC and everybody else interested in this issue that 312 members of the House of Representatives believe that FASB is headed in the wrong direction and that steps need to be taken to alter that course," he said.

Reaction to House Passage of HR 3574

Opponents

- Senate Banking Committee chair Richard Shelby, R-Ala., has refused to allow a committee vote. As quoted in the same San Jose Mercury News story:
 - “Despite this vote, I remain firmly convinced that Congress should not intervene in the FASB rule-making process.”
- SEC sent a letter to the Senate majority leader Bill Frist in August, urging Congress not to interfere with FASB’s process
- Recent quote from Warren Buffet editorial regarding this bill
 - “Give the bill’s proponents an A for imagination – and for courting contributions – and a flat-out F for logic.”

FASB's New Project on Equity-Based Compensation Key Decisions

Recognition of Expense

- Fair value of options as of the grant date (including performance-based awards)
- Recognized over the service (vesting) period
- Generally requires option-pricing model
 - ED cited preference for “open-ended” lattice model (such as binomial)
 - At the September 1st meeting, FASB voted to drop this preference

FASB's New Project on Equity-Based Compensation Key Decisions

Employee Stock Purchase Plans

- FAS 123 currently allows an ESPP with no look-back and a maximum discount of 5% to be treated as non-compensatory
- The ED stated that any ESPP that granted benefits in excess of those available to all other shareholders is compensatory
- At the August 25th meeting, FASB voted permit a discount to be considered non-compensatory as long as the net proceeds obtained are not less than proceeds that would be obtained from an underwriter or other external market source

FASB's New Project on Equity-Based Compensation Key Decisions

Income Tax Effects

- At the August 25th meeting, the Board voted to retain basic approach from FAS 123
 - Expected income tax savings is recorded over vesting period for non-statutory options (creates a deferred tax asset)
 - No tax savings for ISOs, ESPPs until actual tax deduction
 - If actual tax savings exceeds book expense, excess benefit goes to Additional Paid-in Capital (APIC)
 - If actual tax savings is less than amount previously recorded (based on book expense for NSOs), shortfall netted against APIC from prior awards accounted for under FAS 123

If no APIC pool, shortfall increases tax expense

FASB's New Project on Equity-Based Compensation Key Decisions

Treatment of Forfeitures

- Accrue expense based on grant-date forfeiture estimate
- Adjust to accrual based on subsequent revisions in the forfeiture estimates

Non-Employee Transactions

- Non-Employee treatment will be considered in second phase
- For now, EITF 96-18 for all non-employees (fair-value mark-to-market) except directors

FASB's New Project on Equity-Based Compensation Key Decisions

Modifications to Outstanding Awards

- Modifications to include all changes in terms and conditions (e.g., quantity, price, transferability, settlement provisions, vesting)
- Any incremental value transferred to the employee will be recognized as additional expense
 - Difference between modified award's fair value less original award's fair value immediately before the modification
 - If difference is negative, no credit to compensation expense
- Immediate re-pricing is deemed a modification; but no longer results in variable accounting

FASB's New Project on Equity-Based Compensation Key Decisions

Attribution of Expense for Awards with Graded Vesting

- FAS 123 permits both ratable (straight-line or “single option”) attribution (i.e. amortization) or FIN 28 (vesting tranche) attribution
- The ED requires the use of FIN 28 (“multiple option”) attribution for awards with graded vesting
 - Front-loads expense into the early years
- At the August 18th meeting, FASB decided to change the position in the ED and go back to the current approach
 - Choice of methods: (a) If fair value of the award is determined based on tranche-specific expected lives for the options that vest each period, must use FIN 28 method or (b) entity can use either FIN 28 approach or straight-line attribution approach if using a single weighted-average life assumption

Example of Multiple versus Single Option Approach to Attribution

- Grant 1,000 options with fair value of \$10 (\$10,000 total)
- Options vest annually over the 4 year service period
- Straight line approach allows recognition of \$2,500 expense per year
- Multiple option approach (FIN 28) front loads expense as follows:

Award	Year 1	Year 2	Year 3	Year 4	Total
Tranche 1	2,500				2,500
Tranche 2	1,250	1,250			2,500
Tranche 3	833	833	834		2,500
Tranche 4	625	625	625	625	2,500
	5,208	2,708	1,459	625	10,000

FASB's New Project on Equity-Based Compensation Key Decisions

Transition Rules

- Modified Prospective Approach called for in ED
 - Recognize remaining unattributed expense (i.e., expense amounts for portion of options vesting after effective date)
 - Also applies to companies that previously adopted FAS 123 under the Prospective approach
 - Options granted before the effective date will continue to use the original valuation (not the new valuation methodology) and original expense attribution (FIN 28 not required)
- At September 1st meeting, FASB voted to allow a form of “retrospective” or retroactive application, using the amounts shown in the FAS 123 disclosures

Emerging Themes and Popular Alternatives to Stock Options

- Drivers of Change and Design Considerations
- Emerging Themes and Trends
- Popular Alternatives
 - Restricted Stock
 - Restricted Stock Units
 - Performance-based Shares
 - Stock Appreciation Rights

Drivers of Change

- Required fair value expense recognition
 - Fixed expense
 - Eliminates accounting bias for plain-vanilla options
- Continued investor concerns about dilution
- Stock option “failures”
 - “Encourages excessive risk-taking”
 - “Doesn’t produce long-term stock ownership”
 - “Overemphasizes stock price rather than operating performance”
 - “Not correlated with relative performance”
- Gap between option expense and perceived value

**Drivers will vary
in importance by
company**

Considerations for Long-term Incentive Program

- Wealth creation and stability/security for executives and shareholders
- Attraction/retention – creation of ownership
- Drive superior performance
- Overhang/dilution
- Cash flow projections
- Earnings per share
- Investors/competitors

Looking Ahead: Emerging Trends and Themes

- Market Trends (to date)
 - Declining option run rates
 - Increased prevalence of restricted stock / units grants
 - Performance based share grants
- Design Themes
 - Re-evaluating cost / benefit of long-term incentives
 - Tailored incentives
 - Longer vesting / share holding requirements
 - Share conservation techniques
 - Underwater option “cash outs”

Popular Alternatives - Restricted Stock

- Subject to income and payroll tax withholding upon vesting
 - Or upon grant with section 83(b) election
- Retains value even if stock price declines
 - Fewer shares means less dilution
 - Negative connotation: “Pay for pulse”
- More risk-tolerant employees may prefer options – more leverage
- Various methods for determining ratio of RS to options
 - Typical range is one share of RS for every 3 to 5 options

Popular Alternatives - Restricted Stock Units (RSUs)

- Like restricted stock, but combines elements of nonqualified deferred comp
- Represents an unfunded, unsecured promise to deliver shares in the future
- Better tax results compared to restricted stock in some countries where RS is taxed at grant
- In U.S., tax event can be delayed beyond vesting date to predetermined delivery date
 - For broad-based plan, delivery generally same date as vesting
 - FICA applies at vest date, regardless of delivery
 - Recipient can NOT make 83(b) election on RSUs

Popular Alternatives - Performance-based Shares

- Full-value award retains value in declining market
 - Fewer shares means less dilution
- Improved incentive based on appropriate goal-setting (also biggest hurdle)
 - Satisfies recent demands from shareholders for performance-based executive compensation
- Variable accounting under APB 25 goes away with FAS 123 fair value accounting
- Taxed at vesting or at grant with 83(b) election
- Variation: grant shares based on achievement of set goals

Popular Alternatives - Stock-Settled SARS

- Company delivers shares equal to the appreciation upon exercise
 - Cuts share usage and dilution
 - Employee controls timing of tax event
 - Can still go underwater, but can be issued at a discount to provide downside protection
- Company can withhold shares to pay minimum tax withholding, delivers net shares
 - No broker, no commissions, but company must remit cash for taxes
- Variable accounting goes away under SFAS 123 (only for stock-settled)

Other Tax Issues Relating to Equity Compensation

- Proposed Legislation – Deferred Compensation
- IRS Executive Compensation Audit Initiative
- New Final ISO Regulations
- Miscellaneous Tax Developments

Nonqualified Deferred Compensation Legislation

- Legislation pending in both houses of Congress which would impose limitations on timing of deferral elections and distributions.
- Currently awaiting motion to move to Conference
 - House and Senate bills vary slightly
 - Bills have bi-partisan support
- Key Provisions:
 - Deferral election must be made prior to the start of the year in which the income will be earned
 - Changes to timing of distribution will automatically defer payout for an additional 5 years

Nonqualified Deferred Compensation Legislation (continued)

- Key Provisions (continued):
 - Deferrals of restricted stock and option gains are no longer available (Senate bill only)
 - Consider broader application to stock options / SARs?
 - Distributions would be limited to specific stated events (e.g., retirement, separation from service, death, disability)
 - Eliminates use of haircut provisions
- Penalties for noncompliance include:
 - Inclusion of deferred amounts in gross income for the taxable year earned
 - Imposition of interest and penalties

IRS Executive Compensation Audit Initiative

- Executive compensation now targeted in all LMSB corporate income tax audits
- Selected areas of focus include:
 - Nonqualified Deferred Compensation
 - Stock-Based Compensation
 - Section 162(m) compliance
 - Golden parachute payments
 - Split dollar life insurance arrangements
 - Fringe benefit arrangements (esp. corporate aircraft)
 - Employee leasing asset protection plans
 - Form W-2 reporting, payroll, withholding, deductions

IRS Executive Compensation Audit Initiative (continued)

- Companies should be taking a proactive approach to:
 1. Identify “universe” of current executive compensation programs
 2. Consider programs that are “at risk”
 3. Identify executives likely to be reviewed under IRS audit program
 4. Takes steps to come into compliance

New Final Regulations for ISOs

- Issued August 2nd
- Very similar to proposed regulations issued in June 2003
- Intended to clarify and consolidate existing guidance
- Some good news, more bad news
- Effective August 9th, 2004, with some transition rules

New Final Regulations for ISOs

Significant Changes and Clarifications – Some Good News

- Option plan can set overall limit or just limit on ISO shares
 - Based on informal discussion with IRS; technical correction expected
- Offer to change terms of ISO not treated as a modification unless accepted (good) or left outstanding for more than 30 days (bad)
- No bifurcation of options into part ISO, part NSO where company fails to designate
- Share counting: Shares withheld to pay exercise price or withholding tax obligations don't count

New Final Regulations for ISOs

Significant Changes and Clarifications – Some Bad News

- Brokerage fees don't reduce ordinary income on disqualifying dispositions
- If employee exercises early, ordinary income on disqualifying dispositions measured on vest date, not exercise date
 - 83(b) election not respected for regular tax, just AMT
- “Gain limitation rule” denied in cases of wash sale, gifts and sales to related parties
- Information reporting required under §6039
 - \$50 per failure/\$100,000 annual maximum; higher for intentional disregard

Miscellaneous Tax Developments

- ISOs and AMT: Efforts continue to seek relief for individuals caught in AMT trap with declining share value
- NSOs in divorce: Rev Rul 2004-60 clarifies withholding and FICA treatment for options exercised by former non-employee spouse
- Forgiveness of loans to purchase stock: Rev. Rul. 2003-47 holds that reducing or canceling employer loan used to acquire stock results in compensation income

Miscellaneous Tax Developments

- Final regulations issued under Section 861 (sourcing rules)
 - Provides that stock options should be sourced from grant to vesting
 - Common approach had been to source from grant to exercise
 - Consider potential impact to state sourcing
- Proposal to permanently exempt ISOs/ESPPs from withholding requirements: Included in current tax bill pending in Congress, but status of all tax bills this year is iffy

Questions

