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Articles

The Bottom Line on Stock Options Accounting
A Primer on the Expensing of Stock Options

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After years of often tumultuous debate, the new rules of accounting for stock-based compensation plans are here to stay. Congress threatened to legislate them out of existence. The technology industry testified that this accounting rule will lead to the ultimate demise of the industry. But does this rule that requires the expensing of stock-based compensation plans impact your company? The answer is yes if your company, whether publicly-traded or privately-held, utilizes the following types of plans:

• Stock option plans

• Restricted stock plans

• Performance based stock awards

• Share appreciation rights

• Employee stock purchase plans.

The new rules have the potential for tremendous impact on the profitability of companies. This article will guide you through the relevant aspects of the new accounting rule and offer some advice for today's government contractor.

Overview

FAS Statement #123R "*Share-Based Payment*" replaces both APB #25 "*Accounting for Stock Issued to Employees*" and FASB #123 "*Accounting for Stock-Based Compensation*". For publicly-traded companies, it must be implemented in the first interim or annual reporting period after June 15, 2005 while privately-held companies must implement in the first annual reporting year after December 15, 2005 (i.e., in 2006 for companies whose year-end is December 31).

The intent of the Financial Accounting Standards Board (FASB) was to provide investors and other users of a company's financial statements, more complete information as to the financial performance of the company. By requiring companies to calculate the value of the benefit being received from the stock-based transaction, and to recognize compensation expense for the transaction, the FASB felt that the income statement will now better reflect the company's true performance, despite the fact that there is no outflow of cash by the company.

Implementation

Compensation expense will be recognized at the grant date of such options (or other type plans) for the fair market value of the options and will be continue to be recorded over the periods in which an employee earns the right to benefit from the options (the vesting period). The means of valuing the options are left to the discretion of the company, but must meet a set of general guidelines provided by FASB for an acceptable model. Lattice (or binomial) models and closed-form models (such as the well known Black-Scholes) are two such valuation models that meet the requirements of FAS #123R. It is important to note that the choice of model is extremely important as they can generate a wide range of fair value estimates. If you haven't already, you should be contacting your company's accountants for assistance with the choice of model and its implementation.

While the compensation expense calculated above will be reflected on the income statement of the company, you will still need to disclose the following in the footnotes to the financial statements:

• The types of stock-based compensation arrangements the company offers,

• The effect on compensation costs,

• The methodology utilized to estimate the fair value.

Impact on Government Contractors

The utilization of stock option plans and other forms of stock-based compensation has always been a popular means of attracting and retaining key employees for government contractors. This is especially true of small to mid-sized contractors who often have difficulty competing with the large contractors for the brightest and the best talent. The new rule can have a significant impact on the expense structure and profitability of the company. If the company has loan covenants that deal with profitability or various ratios such as debt to equity, then discussions with your banker regarding possible changes to these covenants should be occurring now as opposed to after the year-end when it might be too late.

There has been no guidance issued yet as to whether the compensation expense to be recognized by the company is an allowable expense or not. FAR 31.205-6 deals with the allowability of compensation costs for personal services and includes various types of stock-based awards. Every contractor's stock-based plans are unique to that company and should be analyzed for possible allowability of the compensation costs. Even if the expense is deemed to be allowable, the contractor might still have to support that total compensation to the individual/s is reasonable, especially with the possible large increase that can be reflected from one year to the next.

Finally, there are many companies that are contemplating their sale in the next year or two. When presenting its historical profit and loss performance, the company may want to consider preparing pro-forma financials taking out the effect of the new FASB so as to provide comparability with previous years.

Conclusion

FAS #123R has already had a profound impact on companies, even before the required implementation. Many publicly-traded companies, in anticipation of the new rules, have ceased offering lucrative stock options to its employees and have gone to the usage of restricted stock plans. I have discussed this issue with many employees of these type companies and they all feel that the benefits they now receive are significantly less than before, with the most often quoted reason being the P&L impact of the options on their business unit. Many privately-held companies are now too rethinking their usage of and approach to stock-based compensation plans, so perhaps the technology industry was not merely crying wolf?

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