Equity Compensation Accounting: Sound Decisions in an Uncertain Market
Leveraging FAS 123R to Value and Expense Restructured Compensation

A Live 100-Minute Audio Conference with Interactive Q&A

Today’s panel features:

Alan A. Nadel, Partner, Strategic Apex Group, New York
Thomas D. Miller, Managing Director, Quist Valuation, Broomfield, Colo.
J. Henry Oehmann III, Director, Grant Thornton, Raleigh, N.C.

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The conference begins at:
1 pm Eastern
12 pm Central
11 am Mountain
10 am Pacific

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Equity Compensation Accounting: Sound Decisions In An Uncertain Market Teleconference

June 24, 2009

Alan A. Nadel, Strategic Apex Group
alan.nadel@strategicapex.com

Thomas D. Miller, Quist Valuation
miller@quistvaluation.com

J. Henry Oehmann, III, Grant Thornton
henry.oehmann@gt.com
Program Agenda

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Basic Terms of FAS 123R

Alan Nadel
Applicable Rules

• Generally Accepted Accounting Principles
  – Established by FASB (with input from SEC)
  – Currently followed by U.S. companies
  – Commitment to “convergence” with IASB

• Changeover to IFRS
  – Growing pressure to change over to IFRS
  – Support from SEC, Big Four and Congress
  – But, with some voices expressing caution
  – May be as early as 2010, but more likely 2012 or later
  – Major impact on accounting for U.S. equity-based compensation
FAS 123R – A Refresher

• FAS 123R issued in December 2004
  – Previous rules of APB 25 no longer applicable
  – Requires that the grant date “fair-value” of all equity compensation awards be recognized as expense
  – FAS 123R rules for determining fair value are different than those relating to other assets under FAS 157

• Significant changes in FAS 123R compared with previous rules
  – Stock option valuation models
  – Expense accrual patterns for ratably vested awards
  – Financial accounting treatment of income tax effects
  – Impact of performance vested awards
  – Employee stock purchase plans
Option Valuation Methods

• Two types of option pricing models are allowed for calculation of stock option expense
  – Closed-form (e.g. Black-Scholes)
  – Open-form or lattice-based (e.g. binomial model)

• FASB has no preference
  – Each company is responsible for determining the best model
  – Choice of valuation model between simplicity (Black-Scholes) or precision (Lattice-based model)

• Tom to discuss in greater detail
Awards Other Than Options

• Restricted stock
  – Compensation cost = grant date fair value of the shares

• Restricted stock units (RSUs or phantom stock)
  – If settled in shares, cost = grant date fair value
  – If settled in cash, award is treated as a liability

• Equity compensation treatment (similar to stock options and restricted shares) if awards
  – Are granted to employees for performance of services, AND
  – May be settled only in company shares
Awards Treated Differently

- Liability accounting
  - Applies to any award:
    - That may be settled in cash, or
    - If the underlying shares are classified as liabilities, or
    - If the company can be required to settle the award in cash or some other asset, or
    - That contains other than service, performance or market conditions
  - Results in mark-to-market valuation
    - Measured at grant date the same as equity awards
    - Mark-to-market treatment until award is settled
    - May not utilize equity accounting treatment that applies to awards that are stock-settled
  - Exception for broker-assisted cashless exercises
Compensation Expense Accrual Patterns

• Fair value of equity-based compensation is recognized over service period, which is usually same as vesting period
• For cliff-vested awards:
  – Expense may be amortized over the service period
  – On a straight-line basis
• For ratable-vested awards:
  – Employer may choose between
    • Straight-line (“single option”) amortization OR
    • FIN 28 (“multiple option”) amortization for awards
      – Lower total value, BUT
      – Front-loads expense recognition
Vesting Conditions

• Distinction between service, performance and market conditions

• For service and performance conditions, a charge to earnings is required for vested awards
  – No compensation expense recognized for awards that are forfeited if employment terminates prior to vesting or if a performance condition is not achieved
  – Forfeitures must be estimated up front, and the estimate ultimately trued-up based on actual experience during the vesting period
  – Additionally, compensation expense accrued in prior periods is reversed in period of forfeiture
Vesting Conditions (Cont.)

• If a market condition applies, compensation expense is recognized for all awards granted to participants who remain until end of the performance measurement period
  – Regardless of whether the awards actually vest
  – In other words, NO FORFEITURES for market conditions awards
Determining The Fair Value Of Stock Options

Thomas Miller
The Fair Value Of Stock Options

• What is an option
  – The financial definition

• Two components of option value
  – Intrinsic value
  – Time value

• Valuation models
  – Current value
  – Lattice model
  – Black-Scholes Model
The Fair Value Of Stock Options (Cont.)

• Current value
  – Intrinsic value-only
  – Assumes an immediate liquidation of underlying asset
  – Generally not accepted by auditors

• Lattice model
  – Most accurate
  – Binomial, trinomial, quadranomial…
  – Infinite assumptions – open form
  – Timely and costly
  – Allows for non-asset specific factors
  – Difficult to audit
The Fair Value Of Stock Options (Cont.)

• Black-Scholes Model
  – Closed form model
  – Assumes a normal distribution of returns
  – Six key inputs
    • Value of the underlying asset (stock price)
    • The price the option may be bought or sold for (exercise price)
    • Volatility of the underlying asset (standard deviation)
    • The term of the asset (time to expiration)
    • The risk free rate (match time to expiration)
    • Dividends
The Fair Value Of Stock Options
(Black-Scholes Inputs)

• Value of underlying stock
  – Public traded price
  – Private company
    • Cost, market, income

• Exercise price

• Volatility – daily standard deviation
  – Implied (public companies)
  – Benchmark

• Time to exit

• Risk free rate

• Dividends
Choosing between the models

- **Black Scholes**
  - + Easiest to audit
  - + Least amount of time
  - - Does not account for changing assumptions
  - - Does not account for external factors
  - - It’s probably wrong

- **Lattice model**
  - +/- It may be required
  - +/- Infinite assumptions
  - + Can be the most accurate
  - - Can be manipulated
  - - Very difficult to audit
Repricing Issues

Henry Oehmann
Repricing Of Stock Options

• Repricing stock options is one of the four common types of modifications
  – Repricing
  – Extending the term (i.e., providing the employee additional time to exercise)
  – Reducing the term (i.e., reducing the requisite service period)
  – Increasing the number of awards/shares
Measurement Of Modifications

Measurement
• In substance, considered an exchange of old grants for new ones
• Additional cost is determined based on the difference in fair value of the “new” grant and the “old” grant as of the date of modification

Disclosure
• Nature of changes
How Is A Repricing Of An Option Accounted For?

Example:
On January 1, 2006, company issued **10,000 employee options**, each having an exercise price of $30 and a grant-date **fair value of $8**
On January 1, 2008, the share price had fallen to $20 and the company **lowered the exercise price** of the 2006 options to $20

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of <strong>replied</strong> option on 1/1/08</td>
<td>$5</td>
</tr>
<tr>
<td>Fair value of <strong>original</strong> option on 1/1/08</td>
<td>-2</td>
</tr>
<tr>
<td>Incremental cost to be recognized</td>
<td>$3</td>
</tr>
</tbody>
</table>

Total cost to recognize:

- Original fair value ($8 x 10,000) $80,000
- Incremental cost (3 x 10,000) 30,000

**Total** $110,000
Repricing Of Stock Options

Based on results of Grant Thornton’s recent survey, only 42% of companies are decreasing the value of stock grants made in 2009, when compared to 2008.

What is the rationale for not adjusting the grant value downward, given the current economy?
Repricing “Pro” Issues

Approximately what percentage of your company’s stock options granted and outstanding are currently underwater?
Repricing “Con” Issues

Has your company considered a repricing or exchange to address underwater options?
More Market Data

In response to underwater options, are you granting equity incentives other than options?
Reasons For Repricing Options

• Drop in market value is not indicative of poor company performance or ineffective company management
• Restores employee retention and motivation
• Reduces dilution
• Avoids two classes of employees
• Improves opportunity and incentive to achieve stock ownership guidelines
Reasons Not To Reprice

- Shareholders do not get a “reset”
- Negative market signal
- Removes risk
- Compensation expense
- May lead to shareholder opposition to future stock plan proposals
Repricing: Market Realities

Which arguments do you think are stronger with respect to the repricing of stock options: the arguments \textit{for} repricing or the arguments \textit{against} repricing?

A. The arguments \textit{for} repricing are stronger
B. The arguments \textit{against} repricing are stronger
APIC Pool, Business Combinations And FASB Clarifications

Alan Nadel
Income Tax Benefit

- Tax deduction may be forthcoming as a result of the stock or option award
- Expense determined now; tax deduction comes later (in most cases)
- FAS 123R expense reflects anticipated future tax benefit, in accordance with FAS 109
- Amount of an expense must be offset by any associated tax benefit
- For equity-based compensation, the tax benefit is calculated based on the grant date value of the award and the company’s effective tax rate
Income Tax Benefit (Cont.)

• If actual tax benefit is greater than expected tax benefit
  – Surplus is credited to APIC (i.e., a capital transaction)
  – Is not reflected in the income statement

• If actual tax benefit is less than expected tax benefit
  – Shortfall reduces APIC to the extent of surplus tax benefits from other equity awards accounted for under FAS 123
    • Company must create APIC pool
    • Pool captures prior years’ unused tax benefits under FAS 123
  – If no surplus tax benefits remain in APIC, the shortfall is charged to earnings as additional income tax expense
Income Tax Benefit And APIC Pool

• Additional paid-in capital (APIC) pool
  – APIC pool to establish “look-back” for previous unused tax benefits under FAS 123
  – The pool is reflected in APIC within the equity section of the balance sheet

• Many concerns
  – Determining historical APIC pool, obtaining necessary information, missing data, accuracy of post-1994 footnotes
  – Foreign employees
  – Net operating losses
  – Corporate transactions
    • Pooling vs. purchase
    • Spin-offs
    • Recapitalizations
  – Stock option repricings and other equity modifications
Changes Affecting Equity

• Impact of changes
  – May result in additional expense
  – Special rules applicable

• Types of changes
  – Modifications of equity awards (e.g., repricing of stock options)
  – Business combinations
  – Equity restructurings
  – Cash-outs
Changes Affecting Equity (Cont.)

• Modifications
  – Treated as the exchange of original award for a new award
  – Additional compensation expense must be recognized
    • For any incremental fair value of new award over fair value of cancelled award
    • For any remaining unrecognized grant-date compensation cost
  – Fair values must be utilized – significant difference with income tax rules
  – Fair values compared immediately before and after the modification
Changes Affecting Equity (Cont.)

• Business combinations
  – Treated similar to a modification of the equity award
  – Compare (1) FV of the new acquirer options issued to (2) the FV of the target options being replaced
  – If (1) is less than or equal to (2), then FV of acquirer options is split between purchase price and deferred compensation based on proportion vested (i.e., the proportion of the vesting period that has passed vs. time remaining)
  – If (1) is greater than (2), the amount equal to the FV of target’s options is split between purchase price and deferred compensation based on proportion vested
  – Additionally, the entire excess of (1) over (2) is recorded as deferred compensation by the acquirer
Changes Affecting Equity (Cont.)

- Business combinations
  - Any deferred compensation is amortized as expense by the acquirer over the remaining service (i.e., vesting) period
  - No expense is recognized immediately at the time of the business combination
  - Probability (determined at modification date) of satisfying vesting rules has a significant impact on recognition
Changes Affecting Equity (FAS 141R)

• Business combinations – special rules
  – Accelerated vesting upon business combination
  – If acquirer is obligated to continue or replace target employee awards
  – If acquirer replaces target employee awards when it has no obligation to do so
  – Replacement awards are to be charged to future years in acquirer’s financial statements
Specific Clarifications From FASB

• Rules applicable only to awards for employees
  – FAS 123R continues to apply to awards that are settled after termination of employment (assuming no modifications) – special rule for equity restructurings requires careful document drafting

• Compensation expense is measured at date of grant
  – Grant date deemed to occur upon “mutual understanding”
    • Unilateral grant by company
    • No further ability to negotiate key terms and conditions
    • Timely communication with employees

• APIC pool established for accumulated unused tax benefits
  – Alternative approach for developing APIC pool (different, but still complicated and not feasible for many companies)

• Equity awards subject to cashout upon “contingent events”
  – Liability accounting becomes applicable only when cash settlement becomes probable even will occur – mere possibility is not sufficient
Related SEC Guidance

Henry Oehmann
SEC Guidance Overview

• Following implementation of SFAS 123(R), the SEC issued additional guidance for public companies
  – Staff accounting bulletins: SAB107 and SAB110
  – Focused on implementation issues for public companies
  – More guidance to follow
SAB 110 Key Issues

• Implementation of SFAS 123(R) imposed increased complexity, especially for public companies

• Under SAB 107, filers could use a formula to determine expected term of the option; and

• SEC anticipated this approach would not be used after 12/31/2007
SAB 110 Key Issues (Cont.)

- Simplified formula to determine expected option term
- Proxy disclosure issues
- Alternative approaches
- Phase out
SAB 110 Conclusions

- SEC has issued comment letters for companies continuing to use the “plain vanilla” expected term
- Filers must respond with rationale and action plan
- Most likely, it’s best not to use this approach in the future
SAB 107 Overview

• Released by the SEC on March 29, 2005 to provide its views regarding application of SFAS 123(R)

• Provide assistance to public filers in their initial implementation of Statement 123(R)

• Acknowledged that issuers may have differences in estimating and valuing options
SAB 107 Guidance Topics

• Valuation methods
• Redeemable financial instruments
• Disclosure requirements
• Income tax effects
• Non-GAAP financial measures
• Treatment of modifications under new standard
SAB 107 Guidance Topics (Cont.)

- Share-based payments with non-employees
- Transition issues: non-public to public company
- Classification of compensation expense in the income statement
- Capitalization of inventory of share-based payment costs
- Management’s discussion and analysis disclosures after adoption of new standard
SAB 107 Special Issues

- Employee options
- Valuation methods
- Changes in valuation methods
- Use of historical data as basis
SAB 107 Conclusions

• SAB 107 post-implementation of new standard

• Ongoing guidance from SEC
  – FSP guidance
  – Guidance under Reg. S-K and S-B
  – Other

• Final thoughts

Henry Oehmann
EESA Overview

Established three principal TARP programs designated by the U.S. Treasury Department

- Auction purchase program
- Capital purchase program, and
- Program for systemically significantly failing institutions
ARRA Overview

Objectives:

Review the key executive compensation and corporate governance compliance requirements that were enacted with the AARA bill

- Identify key new areas of the act for compliance
- Compare ARRA to the provisions in EESA
- Identify necessary action steps and a process to implement compliance with regulatory requirements
ARRA Overview (Cont.)

New legislation amended EESA Section 111

- Established new rules, continued existing rules and struck certain certification requirements

- Focus on TARP recipients and provisions affecting the following:
  - Prohibitions on certain types of compensation
  - Plan design-qualitative considerations
  - Compensation clawbacks
  - Income tax deductions, and
  - Corporate governance requirements
ARRA Prohibitions

Prohibitions on the following:

• Bonuses, retention awards and incentive compensation
• Golden parachute payments
• Luxury expenditures
ARRA Key Prohibitions

Prohibition applies as follows:

• Applies to public and private companies

• Bonuses, retention awards, and incentive compensation
  – Number of executives affected by prohibition based on TARP funds received
  – TARP recipient cannot pay or accrue any bonus retention award or incentive compensation during TARP period

• Exception: Long-term restricted stock
  – Stock doesn’t fully vest during TARP period
  – Value doesn’t exceed one-third of total annual compensation
ARRA-TARP Application

- Applies to all public and private TARP recipients
- Applies to SEOs and next five high-paid employees
- TARP recipient cannot make golden parachute payments
- Parachute payments defined as any payment for departure for any reason
- Exception: Payments for services performed or benefits accrued are not treated as a parachute payment
ARRA-EESA Governance Provisions

Board of directors must establish a companywide policy regarding excessive or luxury expenditures, as identified by Treasury

• Expenditures may include the following:
  – Entertainment or events
  – Office and facility renovations
  – Aviation or other transportation services
  – Other activities not reasonable: Staff development, performance incentives or similar non-normal expenditures
ARRA-Plan Design Issues

Plan design consideration are as follows:

- **Limits on compensation to exclude incentives for**
  - Unnecessary and excess risk
  - Threaten the value of the institution

- **Manipulation of reported earnings**
  - Compensation plans cannot encourage manipulation of reported earnings
  - Applies to ALL employees
ARRA Clawbacks

Requires plans to provide for clawback of payments made in the event of the following:

1. Materially inaccurate information
   - Incentive or other compensation payments based on materially inaccurate information
   - Applies to SEOs and next 20 most highly compensated executives

2. Pre-ARRA payments
   - TARP payments received pre-ARRA
   - Applies to SEOs and next 20 high-paid
ARRA-Auction Program Participants

- Applies to public and private TARP recipients
  - If aggregate troubled assets exceed $300 million
  - Exception - doesn’t apply if solely through direct purchase

- Applies to CEO, CFO and next three high-paid executives

- Limits compensation deduction to $500,000
ARRA Corporate Governance

• Requires the establishment of a board compensation committee as follows:
  – Comprised entirely of independent directors
  – Meet semi-annually to discuss and evaluate compensation and risks related to compensation programs

• Shareholder vote on executive compensation

• Certification of compliance
  – CEO and CFO must prepare in writing
  – Applies to public and private companies
TARP Interim Final Regulations

- Released June 10, 2009
- Imposes additional oversight for “exceptional assistance” TARP recipients
- Further expands new rules and limits on executive compensation
- Additional guidance on compensation and corporate governance
TARP Interim Final Regulations (Cont.)

- Special master for compensation
- More restrictions for termination payments in the event of a change in control
- Expanded perquisite disclosures
- Prohibits use of tax gross-up
- Expands “say on pay” guidance
- Directs SEC to establish broader compensation committee requirements and rights
Implications To General Industry

• More regulation and limitations on executive compensation
• Greater focus on risk and risk-base incentives
• “Say on pay”
• Provide compensation committees with the same responsibilities and authority as Sarbanes-Oxley did
• Greater congressional oversight into executive pay beyond tax regulations
Practical Strategies And Recent Examples

Alan Nadel
So, What Is Everyone Doing?

• Preference for Black-Scholes
  – Complications and cost of lattice modeling
  – Volatility calculation
  – More focus on expected term
• Straight-line amortization of expense
• Other steps to manage equity compensation expense
• Ongoing struggle with APIC pool
• Anticipating and budgeting equity plan expense
• Coordination between HR, legal and finance (with tax occasionally invited to the table)
Impact Of Tax And Accounting Rules On Plan Design

• Cutback in the number, and size, of stock option grants
• Greater use of restricted stock and RSUs
  – Less dilutive than options
  – Lower cost than options
  – Gap in perceived value of options
• Alternatives to traditional equity awards (e.g. stock appreciation rights (SARs), especially those settled in shares)
• Less use of incentive stock options
  – No benefit of a deferred tax asset
  – Lost tax deduction
  – Risks of AMT for executives
  – Inadequacy of $100,000 limit
Impact Of Tax And Accounting Rules On Plan Design (Cont.)

- Greater use of performance-based options
  - Market-based
    - Haircut in option valuation
    - No true-up for forfeitures
    - Need lattice to value
  - Non-market-based
    - More difficult to administer
    - Potential swings in earnings

- Employee stock purchase plans
  - Cutbacks not as drastic as first thought
  - Straight quarterly or semi-annual offering periods
  - No look-backs
Impact Of Tax And Accounting Rules On Plan Design (Cont.)

• Net settlement of stock options
  – Advantages
    • Anti-dilutive
    • No broker commission
    • May avoid restrictions for insider trading
  – Disadvantages
    • No cash flow benefit of exercise price for employer
    • Withholding in shares exacerbates employer’s negative cash flow
    • May not be permitted under terms of the plan (particularly ISOs)
    • International issues
      – Might be taxed twice in some countries
      – Withholding at minimum rate is difficult to achieve when determined on a person-to-person basis
Impact Of Tax And Accounting Rules On Plan Design (Cont.)

• Growing frequency of option repricings
  – Focus on nature of equity instruments, pricing, eligibility, vesting
  – Shareholder approval requirements for listed companies
  – International issues
    • Tender offer requirements
    • Tax disclosures
    • Country-specific issues (e.g., Australia, Canada, Netherlands)