CSFB Stock Options Expensing Conference Call
Replay until 4/7/04: 877-519-4471 Pin: 4652480

David Zion, CFA, CPA

- Call coincides with "Expensing Stock Options" report distributed by CSFB on 3/24/04
- FASB issued proposal (Exposure Draft) statement of Financial Accounting Standards on 3/31/04 –includes stock options expensing
- FASB will host roundtable discussions in Q2 2004 – all will be welcome to voice opinions on the issue. Open board meetings will be held in Q3 and Q4 w/ final accounting standard scheduled for Q4. If all goes according to FASB plan, all companies will be required to reflect the fair value of employee stock options as compensation cost beginning in 2005.
- The proposal is the start of a negotiation process – if enough pressure, may scale back later
- Proposed "lattice" or Binomial model – only 8 companies today use Binomial model –rest use Black-Scholes – Binomial is more robust – More on the models will be included in upcoming report
- FASB tried to change the rules on stock options in the early 1990s
    - FASB proposed changes that would have forced companies to record the fair value of employee stock options as a compensation cost through earnings. That proposal sparked severe opposition. The FASB received close to 2,000 comment letters, protest marches were organized in Silicon Valley (the Rally in the Valley), and Congress threatened to put the FASB out of business. The FASB backed down from its proposal, leaving us with the accounting model that we have today.
    - This time around, a number of factors have lined up in the FASB's favor to push through a change in the rules requiring companies to expense employee stock options, including:
        (1) The IASB just finalized its rules that require the expensing of employee stock options by 2005 which removes the argument that this rule change would put U.S. companies at a disadvantage versus their competitors around the globe
        (2) The FASB can now point to the hundreds of companies that have volunteered to expense stock options and say, "Look, if they can do it, you can do it too."

- Will it affect stock prices?
    - The most significant impact of expensing stock options—other than the sledgehammer that it will take to some companies' earnings—is the potential change in behavior it may spark among investors and corporations.
    - Investors will pay closer attention to the cash-flow consequences of employee stock options, particularly the transfer of wealth from shareholders to employees.

    - The FASB may help out here by providing investors with some new disclosures. Companies will pay closer attention to the economic cost of their stock option plans. Companies don't focus much on costs that they don't have to account for. Requiring that a compensation cost be recognized for employee stock options places them on the same playing field as other forms of compensation.
    - There will be a decline in the number of options granted, potentially replaced by restricted stock, cash, incentive options, or nothing if the company had been overcompensating its employees.
    - This is a case study to determine if the market is efficient.
        - If market is efficient, there should be no impact on stock prices if companies are required to expense employee stock options, as the impact on earnings has been disclosed for years. Companies will simply be moving the option compensation cost that had been buried in their footnotes to the face of the income statement.
        - Most analysts don't factor option compensation cost into their earnings forecasts, some companies currently expense options while most don't.
- Impact of expensing stock options on earnings
    - FASB requires most companies to disclose pro forma net income and earnings per share as if the fair value of employee stock options had been charged to compensation expense. Using this disclosure, CSFB estimates aggregate earnings for the S&P 500 would have declined by approximately 8% in 2003, versus 19% in 2002 and 20% in 2001, if employee stock options had been expensed.
    - 22 companies' diluted EPS in 2003 would have dropped 50 cents per share if stock options had been expensed. Semi examples:
        - Agilent (A)
        - Broadcom (BRCM)
        - NVIDIA (NVDA)
        - Advanced Micro Circuits (AMCC)
        - National Semiconductor (NSM)
        - Analog Devices (ADI)
        - LSI Logic (LSI)
    - However, not an issue with some companies; 37 companies would have only dropped by 1 penny or less per share.

- Accounting for Employee Stock Options, Today
    - Under GAAP, companies can choose 1 of 2 methods to determine employee stock option compensation.
        - **Intrinsic value method**
            - Stock options considered form of compensation. Compensation cost is the intrinsic value of the option at the date the number of shares under option and the strike price are fixed. For most options, that is the grant date. So for most options, compensation expense under the intrinsic

value method is the difference between the fair value of the stock and the strike price of the option on the grant date.

- Most companies avoid recording option compensation expense by simply granting "at-the-money" fixed options. By setting the strike price equal to the then-current stock price, the option has no intrinsic value on the grant date, and therefore, no compensation expense is recorded.
- Vast majority choose intrinsic, or "no expense" method; 383, or 77%, of S&P 500 companies use intrinsic value method

- **Fair value method**
  - The fair value method is the FASB's recommended approach in FAS No. 123. Under the fair value method, employee stock options are valued at the date of grant using an option-pricing model such as Black-Scholes or Binomial. That option value is fixed at the date of grant and charged to compensation expense over the option vesting period (generally between three and five years).
    - For example, if a company determines that an option grant has a fair value of $3 million and the vesting period is three years, the company will record $1 million of compensation expense in each of the next three years. As fair value is not adjusted for subsequent movement in the stock price, the company would still record the $1 million per year compensation cost even if the stock price were to move down and the options became worthless.
  - Today, 117 companies on S&P 500 that use fair value method, up from 2 companies just a few years ago. These 117 account for 40% of S&P's market cap.