

# OPTIONS EXPENSING

## Trends and Issues in the Implementation of FAS 123(R)

*The introduction of FAS 123(R) has prompted a number of implementation-related questions from companies with employee stock option programs. Which options pricing model are most companies using? How are companies and sell-side analysts accounting for options expense in their earnings estimates? Should prior year numbers be restated to include options expense? Thomson Financial surveyed nearly 400 publicly-traded companies in an effort to answer these and other questions. For more information about this report, contact Paul Davee, [Paul.Davee@thomson.com](mailto:Paul.Davee@thomson.com); or Kara Newman, [Kara.Newman@thomson.com](mailto:Kara.Newman@thomson.com).*

### KEY FINDINGS

- The vast majority of companies have not started expensing employee stock options using FAS 123(R) accounting.
- Most companies are continuing to use or plan to use the Black-Scholes model to calculate their options expense.
- The majority of companies have not or do not plan to restate prior year numbers that include options expense.
- Nearly 58% of respondents have included or plan to include options expense in their earnings guidance. However, of these, close to half also said they have provided or plan to provide both an earnings guidance number that includes options expense AND a number that excludes the cost for the same period.
- About 32% of **all** companies have provided or plan to provide two sets of earnings estimates -- one that includes options expense and another that doesn't -- for the same period.
- Sell-side analysts are not including options expense in their earnings estimates for many companies.
- Compared to companies that issue an earnings estimate that excludes options expense, or give two earnings estimates (one including the expense and the other excluding it), companies that provide an estimate that includes options cost appear to have a higher rate of sell-side analysts include the expense in their forecasts.
- On an industry level, the healthcare sector has the highest rate of companies using two sets of estimates (with and without options expense) as well as one of the highest rates of majority analyst estimates excluding options expense. The staples sector, on the other hand, is the lightest user of two sets of estimates and has the lowest rate of majority analyst forecasts excluding options expense.
- About 45% of companies have cut or plan to cut their option grants. Of these, about 73% are using or planning to use restricted stock/restricted stock units to offset the options reduction.
- A full 67% of companies have not seen or do not expect to see options expensing have a negative impact on their stock price.

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## Summary

Driven by calls for clearer reporting on financial statements and increased scrutiny of executive pay, the Financial Accounting Standards Board issued FAS 123(R) on December 16, 2004. The ruling requires companies to calculate the grant-date fair value of stock options awarded to employees, and amortize that amount over the vesting period as an expense through the income statement.

FAS 123(R) eliminates the choice previously available under its predecessor, FAS 123, for companies to calculate options expense using the APB 25 intrinsic value method, which often resulted in zero compensation cost.

Intrinsic value is simply the difference between the option exercise price and the stock price on the grant date. When options were granted with an exercise price equal to the stock price on the grant date, as was often the case, the intrinsic value was zero, and thus no options expense was recognized in the income statement.

However, companies that used the intrinsic method were also required to disclose in financial statement footnotes pro forma earnings, calculated as if the company had accounted for options using the fair value method, which takes into account a number of other factors, such as volatility and dividends, that create value.

In short, with FAS 123(R)'s introduction, stock option grants, for the most part, now carry a cost that lowers a company's reported income.

While a number of companies are already expensing employee stock options in accordance with FAS 123(R), many others, particularly in the technology and health-care sectors, have yet to start.

Still, nearly all companies will soon be required to account for stock options as an expense. For public companies that are not classified as small businesses, FAS 123(R) is effective for fiscal years beginning after June 15, 2005. For companies with a calendar year-end, that will be the March 31, 2006 quarter.

As options expensing quickly becomes the law of the land, companies with employee stock options face a myriad of new valuation, disclosure and compensation issues. To identify trends in how companies are addressing these and other issues related to FAS 123(R)'s adoption, Thomson Financial surveyed 386 public companies, representing an array of industry sectors and market capitalizations. **(Fig. 1, Fig. 2)** A summary of these issues and trends follows:

- One of the biggest questions companies face is how to determine the value of options, which are contracts to buy shares of stock over a fixed period in the future for a preset price. Since there are no active markets for employee stock options, mathematical models are used to value them. The FASB has approved two such models -- Black-Scholes and lattice -- for estimating the fair value of stock options. While Black-Scholes has long been companies' preferred pricing model, due to its relative ease of use, some observers have predicted that the lattice model will gain in popularity, given its potential to produce a more accurate valuation. However, the survey suggests that most companies are still using or planning to use Black-Scholes, and almost none have plans to switch to a different model in the future.
- Companies must also decide whether to restate prior-year earnings to include options expense. The survey suggests that many companies are not restating, instead choosing to adopt FAS 123(R) on a prospective basis only.
- Another key question facing corporate management is how companies and the analysts that follow them are accounting for options expense in their earnings estimates. The survey results show that 58% of companies have included or plan to include options expense in their earnings guidance, with many of these also saying they have issued or plan to issue two sets of estimates -- one that includes options expense and another that excludes it -- for the same period.

However, for many companies, the sell-side analysts covering them are not including options expense in their forecasts. As such, companies and analysts are not always on the same page when it comes to the recogni-

tion of FAS 123(R) in earnings estimates, creating the potential for unduly negative comparisons when investors try to determine how a company's published earnings stack up against the mean analyst estimate. Still, the survey results indicate a greater incidence of analysts including the expense in earnings estimates for companies that recognize the cost in their profit forecast (and do not provide an additional estimate excluding the expense) than for companies that exclude the cost from their guidance or issue two sets of estimates (with and without the expense).

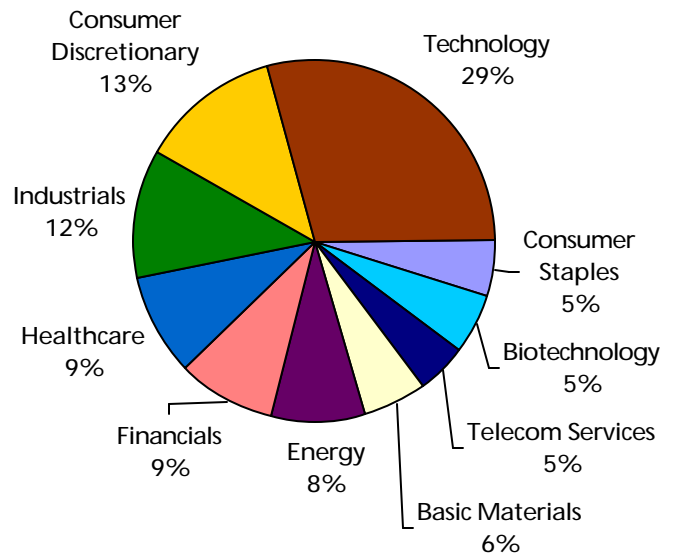
- Debate has also centered on whether companies should issue pro forma earnings that exclude options expense. Most companies are either not using (or planning to use) pro forma earnings metrics or are undecided on the issue. Some of the uncertainty may stem from not knowing how analysts will treat the expense in their estimates.

- Given that option awards now lower a company's bottom line, a number of companies are faced with the question of whether or how to adjust their employee compensation plans to reduce the earnings hit. The survey results are in line with other studies showing that companies have been slashing their option grants. Of these companies, most are using restricted stock to offset the reduction in options granted.

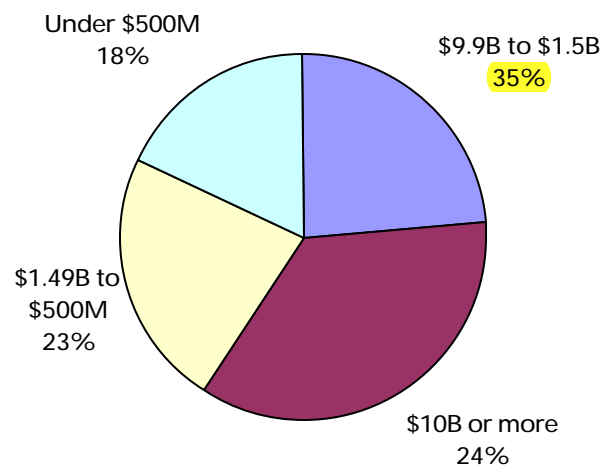
- When implementing the new accounting rules, companies should consider whether options expensing will have a negative impact on their stock price. This may help a company determine whether steps taken to reduce options expense, such as adjusting compensation strategies and using a complicated pricing model like lattice, are worth the added effort. The vast majority of companies surveyed said they do not expect options expensing to hurt their stock price.

**For a technical overview of FAS 123(R) and its requirements, please see Appendix C.**

**Fig. 1: Participants by Industry**



**Fig. 2: Participants by Market Capitalization**



## Discussion

### Companies Waiting to Adopt FAS 123(R)

Most companies surveyed (65%) had not started expensing employee stock options using FAS 123(R) accounting. (Fig. 3) On an industry level, it appears that the vast majority of healthcare and technology companies are waiting as long as possible to implement the new accounting rules. These sectors showed the greatest incidence of companies that had not adopted FAS 123(R). A full 86% of healthcare respondents and 76% of technology respondents had not begun expensing stock options in accordance with the new rules. (Fig. 4)

Healthcare and technology firms have traditionally been the biggest issuers of employee stock options and would therefore experience the biggest hits to their bottom lines once options are expensed. Thomson analysis shows that for S&P 500 technology and healthcare companies that have not yet adopted FAS 123(R), earnings per share over the last 12 months would have been negatively impacted by 24% and 7%, respectively, had those companies expensed stock options. That compares with an EPS impact of 4% for all S&P 500 companies that did not expense options during the last four quarters. Financial, basic material and utility companies' EPS would have been the least affected, with an EPS impact of 1%. (NOTE: These figures are price weighted)

Fig. 3: Started Expensing Stock Options?

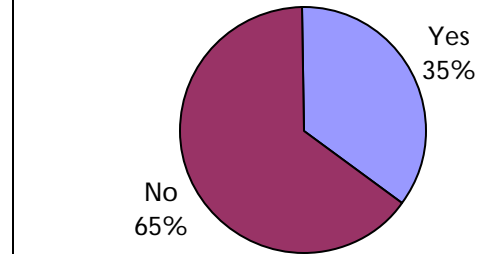
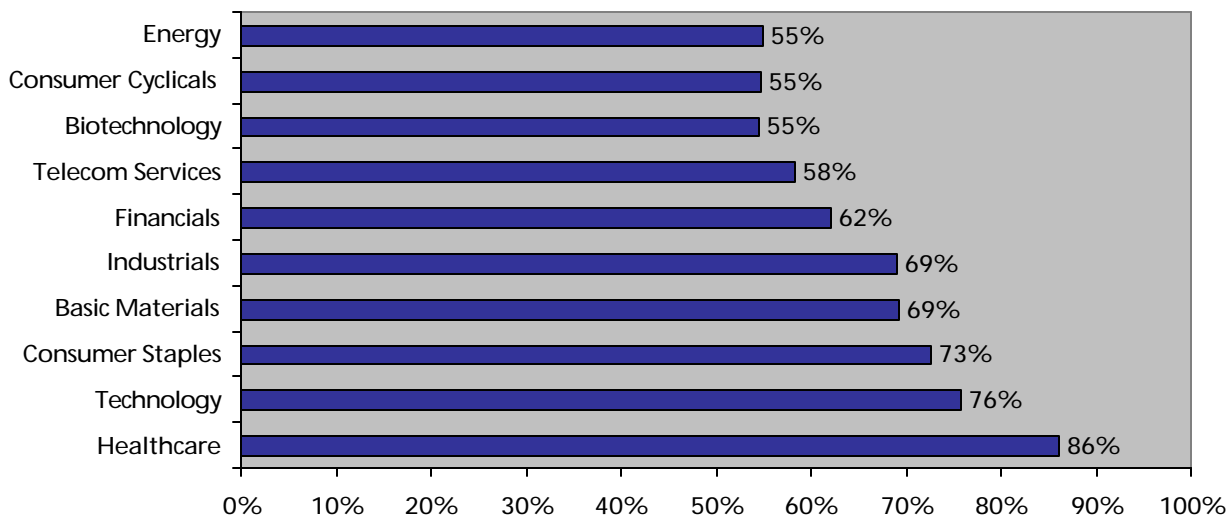
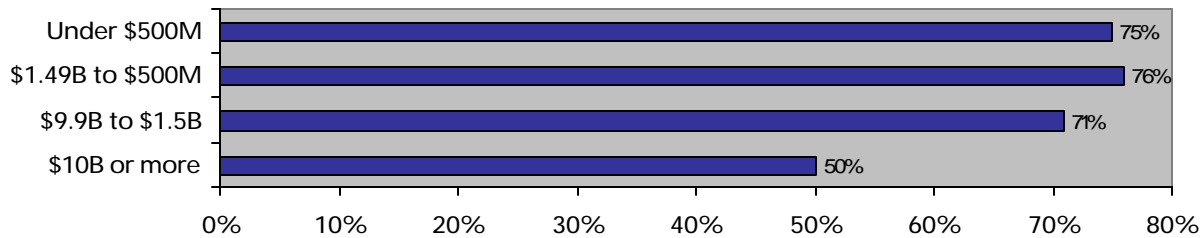


Fig. 4: Percentage of Each Sector that Not Yet Expensing



Meanwhile, over 70% of companies with market capitalizations ranging from under \$500 million to \$9.9 billion are currently not expensing stock options. That compares to 50% of companies with market caps of \$10 billion or more that haven't started expensing. (Fig. 5)

Fig. 5: Percentage of Each Market Cap that Not Yet Expensing



## Valuing Stock Options

### Black-Scholes Remains the "It" Model

The vast majority of respondents (about 64%) said they are using or are planning to use the Black-Scholes model to calculate the fair value of their options expense. Meanwhile, only 10% said they are using or planning to use a lattice model. (Fig. 6)

Moreover, survey results showed significantly greater use or planned use of Black-Scholes over lattice in all the major industry sectors and market caps. Meanwhile, lattice use or planned use was slightly heavier among larger cap companies than smaller cap companies. (Fig. 7) Among the various industry groups, lattice use was relatively even.

Fig. 6: Pricing Model Use

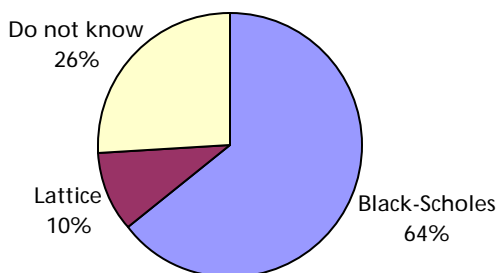
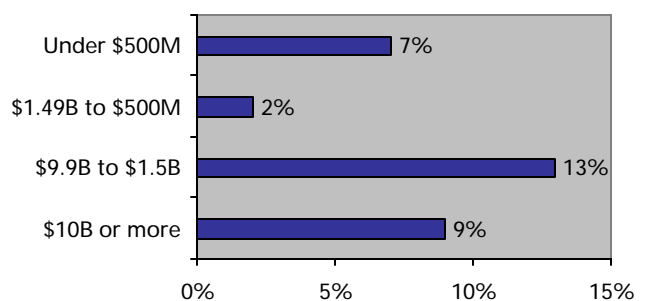


Fig. 7: Lattice Use by Market Capitalization



### Reasons for Model Choice

The primary reasons companies said they were using or planning to use **Black-Scholes** were ease of use (69%) and a perception that it is the most widely used model (60%). A large portion of respondents also cited lower implementation costs (43%). (Fig. 8)

Among the “other” responses (6%), a number of companies said they are using or planning to use Black-Scholes because they were already using the model for required footnote disclosures. Moreover, some said they want to remain consistent with historical options expense valuations.

Meanwhile, nearly all of the respondents who are using or planning to use **lattice** said they are doing so because of an expectation that it will produce a more accurate valuation than other models. The next most prevalent reason for using lattice was an expectation that it will yield a lower valuation than other models. (Fig. 9)

**Fig. 8: Reasons Given for Black-Scholes Use**

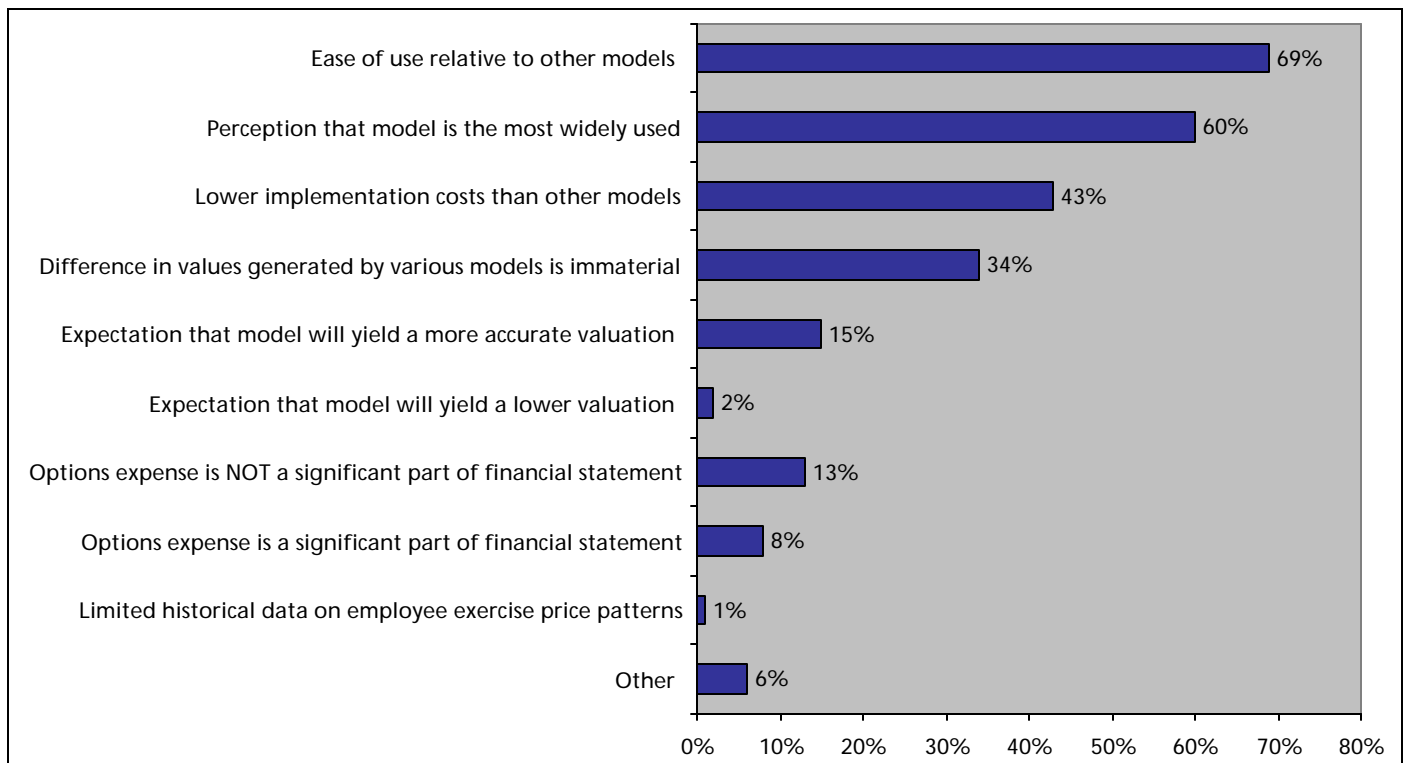
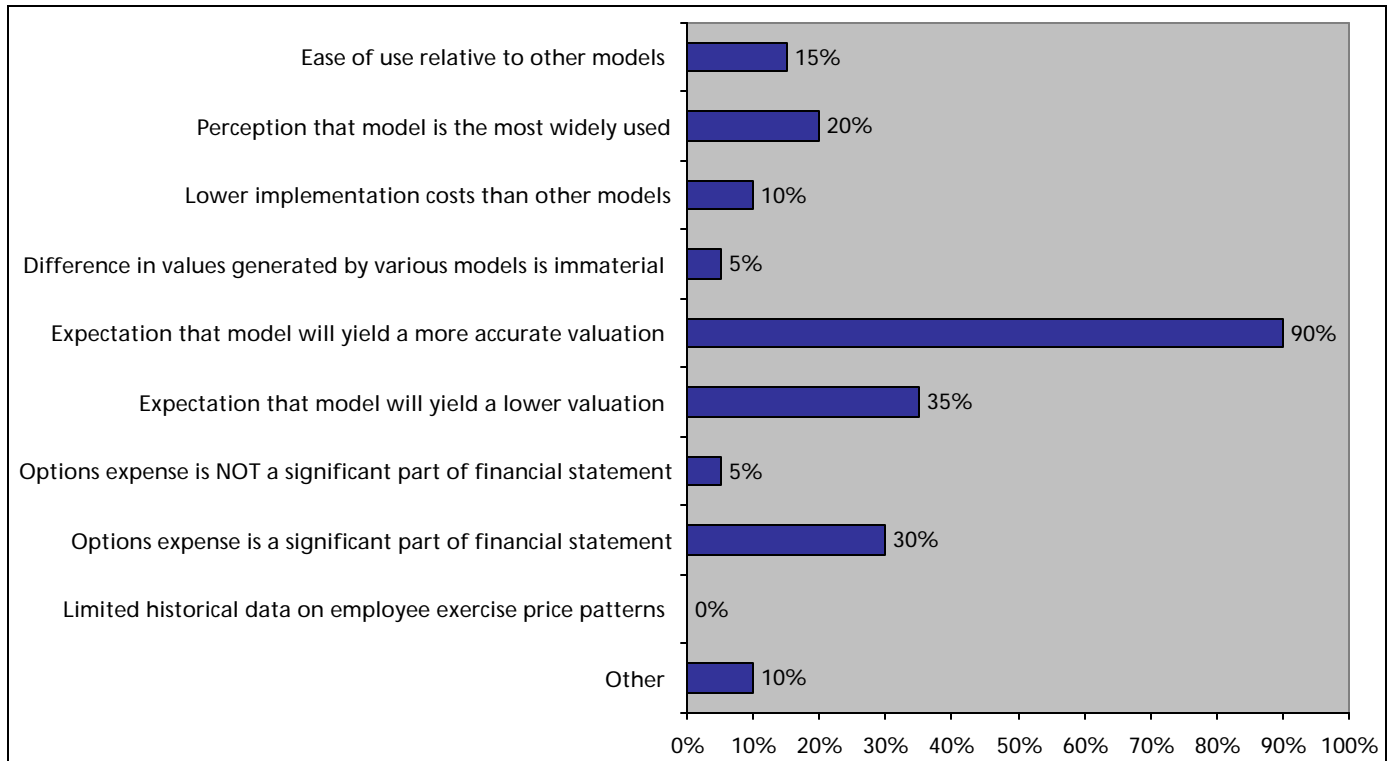


Fig. 9: Reasons Given for Lattice Use



### Lattice vs. Black-Scholes

Black-Scholes has long been the preferred choice of companies. According to FAS 123(R), there are several valuation techniques that companies can use to accurately determine the fair value of options. The rule specifically mentions lattice models, such as binomial lattice, and closed form models, like Black-Scholes, as acceptable, but implies a preference for lattice in providing the most accurate estimates. Still, most companies have chosen Black-Scholes because it is significantly easier to use.

Black-Scholes is not without its critics, however. A primary criticism of the model is that it is too static to capture the dynamic fluctuations that occur in the actual market and business climates. Unlike lattice, Black-Scholes assumes that option exercises occur only at the end of an option's contractual term. In addition, many of the input variables, like volatility and dividends, are considered constant over the option's term. On the other hand, lattice can accommodate dynamic assumptions of expected volatility and dividends, and it allows companies to incorporate actual option-pricing behavior into their estimates.

Meanwhile, a main drawback of lattice is that it requires companies to track a wider array of data, potentially adding to compliance costs. In addition, a number of companies, particularly newer ones, do not have sufficient historical data on employee exercise price patterns to make using a lattice model worthwhile.

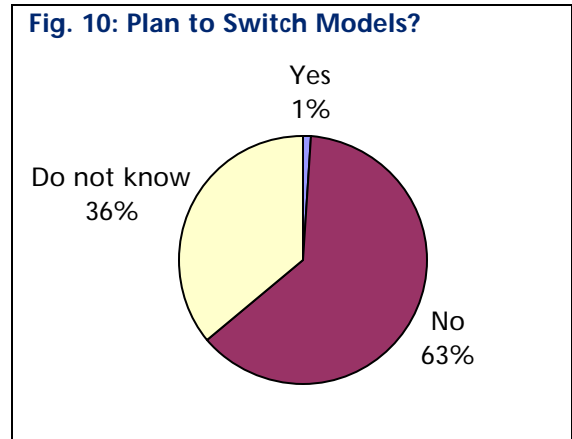
*Option expense will be ignored by the investment community and our intention is to comply with the rules with the least amount of effort. -- small cap technology company using Black-Scholes*

In addition, some companies, particularly those that provide little compensation in the form of stock options, may find that estimates of their options expense derived from Black-Scholes are not materially different from those generated by a lattice model. In such cases, companies may also determine that using a lattice model is not worth the added effort. Nearly 34% of survey respondents said a reason they are using or planning to use Black-Scholes is an "expectation that the difference in values generated by various models is immaterial."

#### **Lattice to Gain Converts?**

Given the lattice model's flexibility and potential for enhanced valuation accuracy, some experts have predicted that lattice models will gain in popularity as companies compile more accurate and detailed data about their employees' historical exercise price patterns. In fact, results of a recent study by AON indicated a slight increase in the use of lattice models since the end of 2002.<sup>1</sup>

However, when respondents in Thomson Financial's survey were asked whether or not they intend to switch to a different pricing model in the future, 63% answered 'no' while 36% said they are unsure. Just 1% indicated an intention to switch to a different model. (Fig. 10)



#### **Many Companies Undecided**

Out of the respondents who have not yet started expensing options, nearly 52% said they do not know what pricing model their company plans to use, suggesting that a number of companies may still be undecided about how they are going to implement FAS 123(R). Out of the respondents who said they have begun expensing stock options, only 16% said they did not know what pricing model their company is using.

#### **Market-Based Approach**

While the FASB specifically identified Black-Scholes and lattice as acceptable means of valuing employee options, it also left the door open for companies to design alternative pricing methods. Some companies, particularly those with substantial option grants, have tried to take advantage of this "wiggle room" on the valuation front.

In a bid to achieve the most accurate valuation possible, Cisco Systems, for its part, asked the Securities & Exchange Commission in May 2005 for approval of a market-based approach that would involve selling a new class of securities, whose trading would render an estimated value for its employee stock options. In essence, a tradable derivative would be created that would allow the company to base its options value on what investors would pay.

However, in September 2005, the SEC's chief accountant said he had "significant doubts" about using a market-based approach like the one proposed by Cisco. To date, no company or organization has created a market-based method for valuing employee stock options that has been deemed acceptable by the SEC.

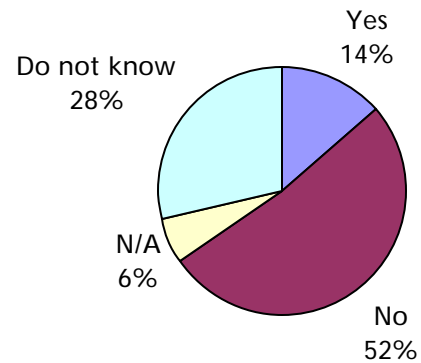
No respondents in Thomson Financial's survey said they were considering a market-based approach.

### Retrospective Transition?

FAS 123(R) allows companies to choose one of two methods -- modified prospective or modified retrospective -- for transitioning to the new expensing rules.

Under the modified prospective method, companies must start expensing the fair value of new options granted and the unvested portion of prior grants. Meanwhile, the modified retrospective method requires companies to charge the same amounts of compensation expense, previously disclosed in pro forma footnote disclosures, to earnings for prior periods. For periods after adoption of FAS 123(R), the modified prospective method is applied.

Fig. 11: Restate Prior Results?



It appears that most companies are not using or planning to use the retrospective method, as only 14% of respondents said they had gone back or planned to go back and include options expense in prior year numbers. (Fig. 11)

A full 52% of respondents said they have neither restated nor do they plan to restate prior year financial results to include options expense. About 28% said they did not know whether their companies had restated or planned to restate. This trend was relatively consistent across industries and market capitalizations, with far more companies answering no than yes to the question of whether they restated or planned to restate.

FAS 123(R) does not require companies to include the expense in prior year numbers. As such, companies can save on time and cost by reporting the expense on a prospective basis only. Still, some companies have elected to restate prior results to make it easier for analysts and investors to make year-over-year and quarter-over-quarter comparisons.

However, a number of companies do not anticipate a benefit from including options expense in prior year numbers because the impact had previously been stated in footnotes, in accordance with FAS 123, the predecessor to FAS 123(R).

*We don't plan to recalculate options expense impact going backwards because the impact has been footnoted in our 10K reports. -- Mid-cap technology company*

**Earnings Guidance**

Another issue companies face is whether or not to include options expense in their earnings guidance.

About 58% of respondents said they have included or plan to include options expense in their guidance, while only 13% of companies said they have excluded or plan to exclude the cost from their forecasts. (Fig. 12)

The high rate of respondents who answered 'not applicable' was unsurprising, given that a number of companies have policies of not giving guidance.

On a sectoral level, the consumer staples sector was the heaviest user of guidance reflecting the options impact, with 82% of staples companies saying they have given or plan to give forecasts that include the cost. Healthcare (71%) and industrial firms (69%) were the next biggest users. The smallest users were the basic material (31%) and energy (40%) sectors. (Fig. 14)

Based on market capitalization, the popularity of guidance reflecting options expense was lowest among small cap companies, with 46% of those firms saying they have given or plan to give guidance that includes options expense. Use of earnings forecasts including the cost was relatively even across the other market caps at about 60%. (Fig. 15)

**Two Sets of Estimates?**

When asked if they had provided or planned to provide both guidance that includes options expense AND an estimate that excludes it for the same period, 32% of respondents answered 'yes,' while 31% responded 'no.' (Fig. 13)

Use or planned use of two sets of earnings estimates was greatest in the healthcare (57%), telecom service (50%) and technology sectors (39%). Meanwhile, this type of guidance was least prevalent among consumer staple (9%), energy (15%) and industrial (21%) companies.

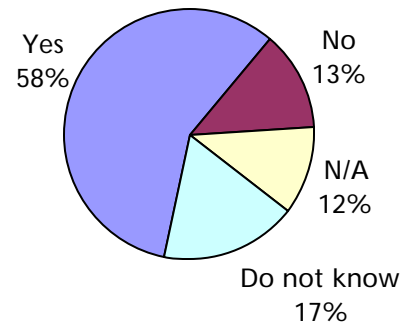
Based on market capitalization, companies with market caps of \$1.49 billion to \$500 million were the biggest users at 40%, while those with market caps of \$10 billion or more were the lightest users at 26%.

Of note, many of the companies that said they included or planned to include options expense in their earnings guidance also said they issued or planned to issue both an earnings guidance number that reflects options expense AND a number that does not reflect the cost. Of the companies who said they have given or plan to give guidance including options expense, 48% indicated they have concurrently issued or plan to issue another estimate that excludes options expense. About 34% indicated they did NOT issue or plan to issue a concurrent forecast excluding options cost.

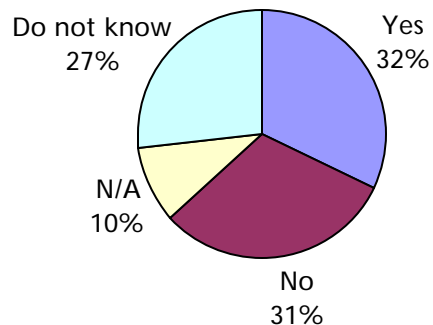
**Guidance Considerations**

Companies may choose to exclude the expense from guidance for a number of reasons, such as immateriality of the expense amount and difficulty in predicting the company's future use of options as a form of employee compensation.

**Fig. 12: Include Options Expense in Guidance?**



**Fig. 13: Provide Two Sets of Estimates?**



Meanwhile, companies with material options expense might include the expense in their guidance in an effort to lessen the impact, if any, on the company's stock when earnings are reported using FAS 123(R) accounting.

Companies might also include options expense in their guidance to help ensure that the analysts covering them also include the expense in their estimates. This in turn would make it easier for investors to quickly determine whether a published earnings number met, exceeded or missed consensus analyst estimates, and help to prevent any unduly negative comparisons.

*It would be our preference to only issue GAAP guidance, but if other companies in our industry issue both we will do the same. -- Large-cap technology company*

*We are waiting to see what the majority of other companies do before committing to a methodology or guidance process. My sense is that the analysts will be backing out the options expense in their estimates. -- Mid-cap technology company*

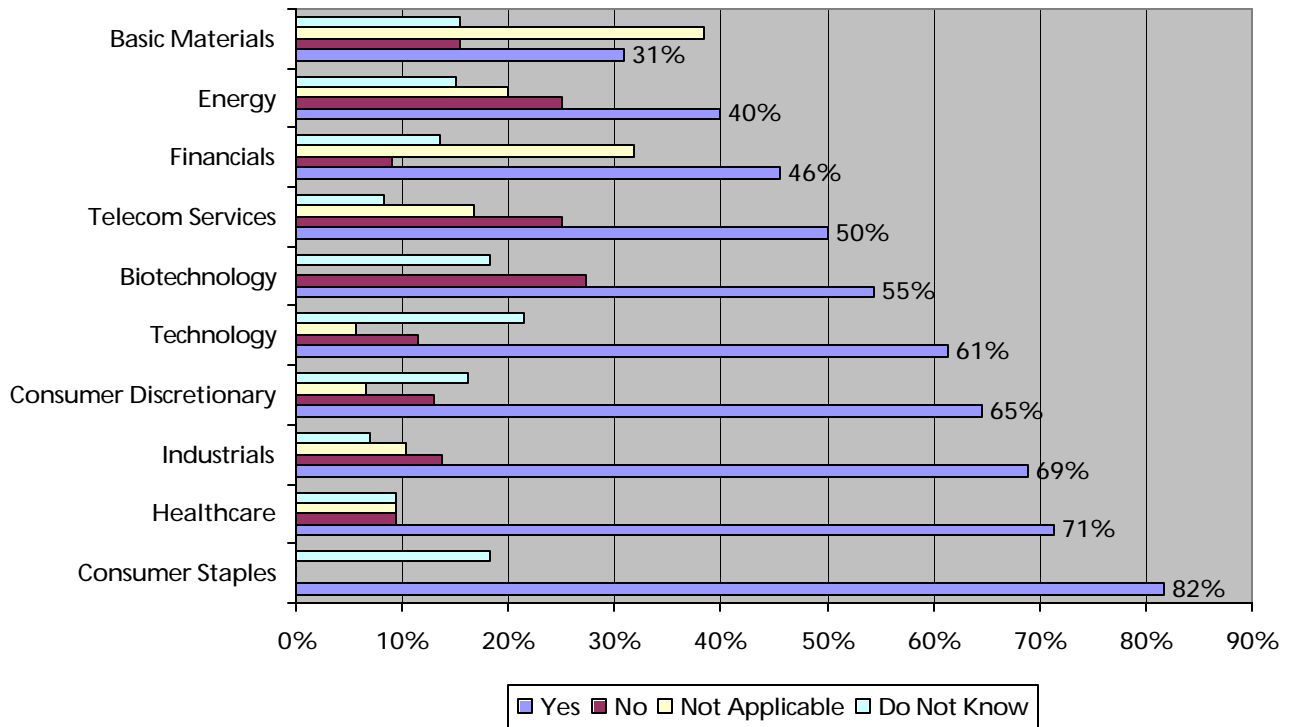
*The guidance for the first year will include both option expense and a number that excludes it for the same period, for prior year comparison purposes. After year 1 of adoption, we plan simply to go with the expense that includes SOE. -- Mega-cap consumer discretionary company*

*Equity comp is a labor cost, and should be included in reported numbers and forward looking statements. -- Mega-cap technology company*

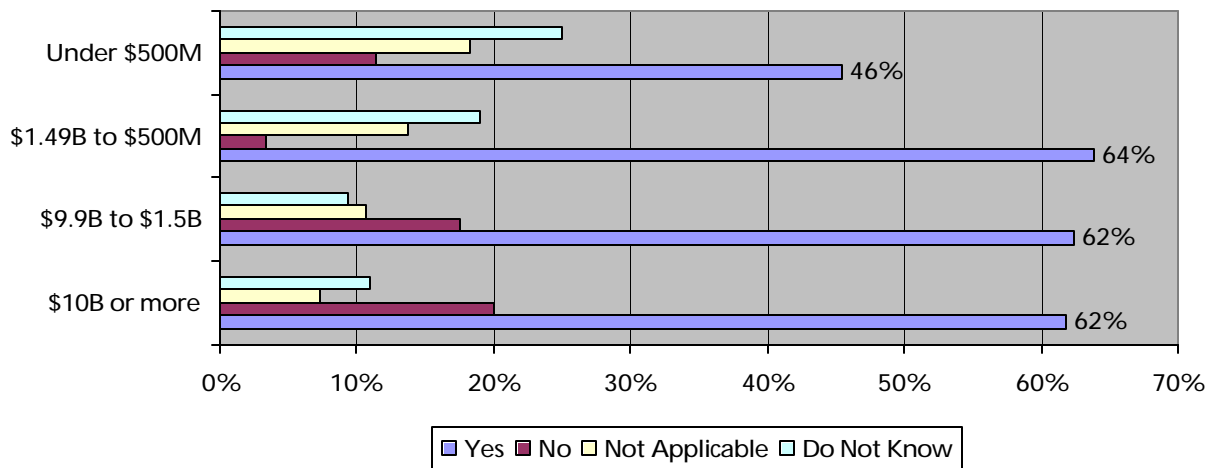
*We're most likely going to provide guidance as usual: GAAP and non-GAAP. GAAP will include options expense and non-GAAP will exclude option expense. -- Mid-cap technolog company*

*We expect to give guidance including option expense and also to give the option expense cost. We don't plan to give non-GAAP guidance excluding options expense. -- Large-cap healthcare company*

**Fig. 14: Including Options Expense in Earnings Guidance?**



**Fig. 15: Including Options Expense in Earnings Guidance?**



### Sell-side Analysts Excluding Options Expense

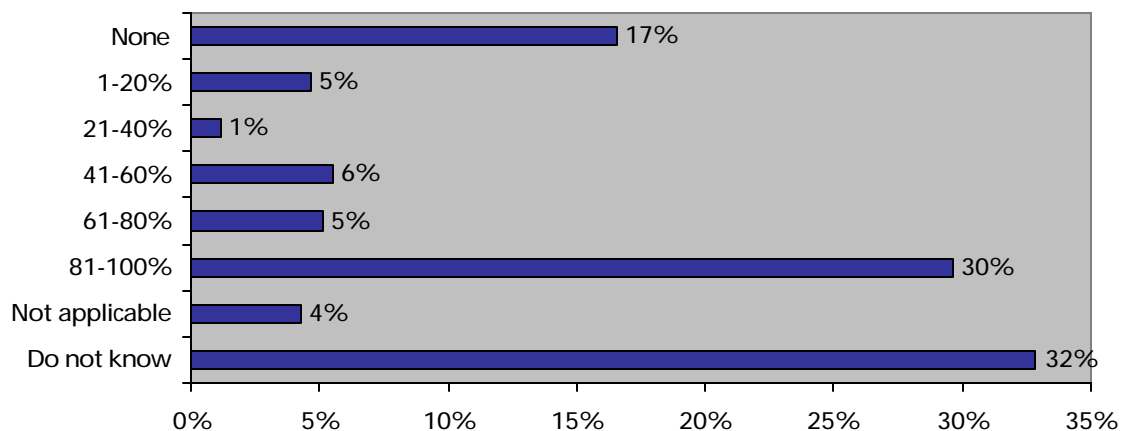
Survey results suggest that, for a number of companies, the sell-side analysts covering them are not including options expense in their earnings estimates.

About 47% of respondents said at least one sell-side analyst covering their company excluded options expense from its most recent estimates. Moreover, at least 35% said the majority of analysts covering them excluded the expense, and nearly 30% said 81-100% of the analysts covering them excluded the cost. **(Fig. 16)**

In contrast, up to 29% said the majority of analysts included the expense in their most recent estimates. Only 17% said all their analysts included the expense.

About 32% of respondents did not know the answer to the question.

**Fig. 16: Percentage of Analysts that Excluded Options Expense from Estimates**



In addition to showing that a number of sell-side firms are still excluding options expense from their estimates, the survey results also indicate a greater prevalence among respondents of majority earnings estimates excluding the expense than majority estimates including it.

A look at 2006 earnings estimates submitted to Thomson First Call confirms this trend. Majority analyst estimates excluded options expense for 76 companies. That compares to 40 companies for which the majority of analyst estimates included options expense. (NOTE: These figures are derived from a review of analysts' 2006 estimates for all U.S. companies covered by First Call, submitted as of November 5, 2005.)

On an industry level, the survey showed that the healthcare, biotech and technology sectors said most often that the majority of their analysts excluded options expense. About 50% or more of the respondents in each of these sectors indicated that the majority of their analysts excluded options expense from their most recent estimates. The energy and staples sectors had the lowest incidence of majority analyst estimates that excluded the expense.

Based on market cap, the \$9.9 billion to \$1.5 billion segment had the highest percentage companies indicate that the majority of their analysts had excluded options expense from their most recent estimates. Market caps of \$10 billion or more had the lowest rate of majority estimates excluding the cost.

### How Options Expensing Affects Estimates on Thomson Financial First Call

Currently, Thomson publishes an EPS mean that includes options expense only when the majority of the contributing analysts include the expense in their estimates. When the majority of analysts include options expense in their estimates, the remaining estimates that do not include the expense are excluded from the EPS mean calculation. Conversely, when the majority of contributing analysts exclude options expense from their estimates, the remaining estimates that include options expense are excluded from the EPS mean.

Due to inconsistencies in analysts' recognition of options expense in their estimates for companies, Thomson Financial will soon begin publishing side by side both a mean estimate for analysts' forecasts that include options expense and another mean for analysts' estimates that exclude options expense.

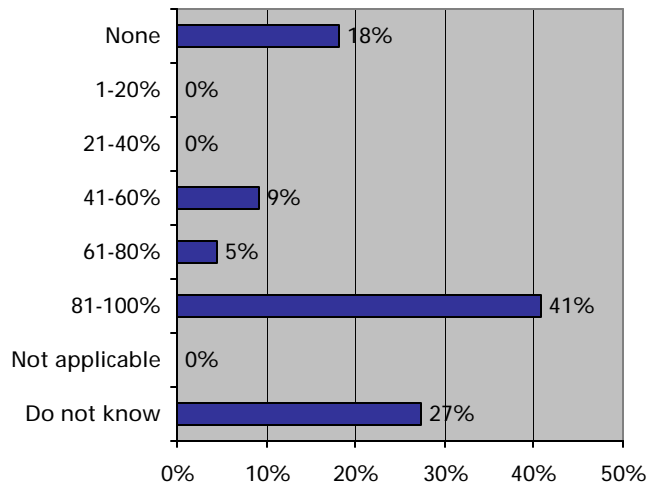
#### Sell-side Following Companies' Lead

To the extent companies exclude options expense from their guidance, analysts might be led to exclude the cost from their estimates as well. While a host of sell-side firms have instituted policies requiring their analysts to include options expense in their estimates, a number of other firms have not.

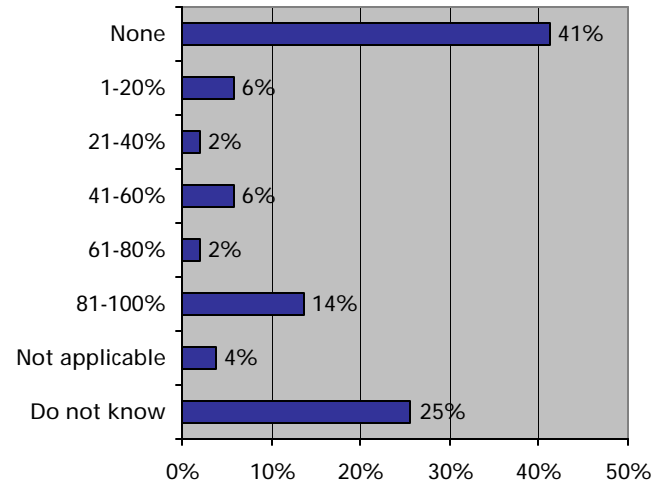
Indeed, the survey results suggest that compared to companies that included or planned to include options expense in their earnings guidance, companies that excluded or planned to exclude the expense from their estimates had more analysts also exclude the expense from their forecasts.

Out of respondents who said they excluded or planned to exclude options expense from their estimates (and did not provide or plan to provide an accompanying estimate including the expense), nearly 41% said 81-100% of the analysts covering their company excluded options expense from their most recent estimates for the company. Also, at least 46% said the majority of analysts excluded the expense. **(Fig. 17)** Meanwhile, just 14% of the companies that included or are planning to include the expense in their guidance (and did not provide or plan to provide an accompanying estimate excluding the expense) said 81-100% of the analysts covering them excluded the expense. Moreover, up to 22% said the majority of analysts excluded the options impact. **(Fig. 18)**

**Fig. 17: Percentage of Analysts Excluding Options Expense from Estimates for Companies that Excluded Expense from their Guidance**



**Fig. 18: Percentage of Analysts Excluding Options Expense from Estimates for Companies that Included Expense in their Guidance**



The survey also suggests a tendency for companies that have provided two sets of earnings estimates -- one that includes options expense and another that doesn't -- for the same period to have a significantly greater percentage of analysts exclude the expense from their estimates than is the case for companies that have given an estimate including options cost that is NOT accompanied by an additional estimate excluding it.

Moreover, results indicate that companies providing two sets of earnings estimates (with and without options cost) appear to have nearly the same rate of analysts exclude the expense from their estimates as companies giving an estimate excluding the cost that is NOT accompanied by another estimate including it.

The lower rate of analysts excluding options expense from their estimates for companies that recognize the cost in their guidance and do not provide two sets of estimates was also reflected on a sector level. The staples sector, which was the heaviest user of earnings guidance including options expense and the lightest user of two sets of estimates, had the lowest rate of companies saying the majority of their analysts excluded options expense from their estimates. Meanwhile, the healthcare sector, which was the heaviest user of two sets of earnings estimates, had one of the highest rates of companies saying the majority of their analysts did not account for options cost in their forecasts.

**Confusion Anticipated**

In cases where the majority of analysts exclude options expense from their estimates for a particular company, confusion could arise when investors and the media try to determine whether the company's reported earnings met, beat or missed the consensus analyst forecast.

However, given that analysts appear to be following companies' lead in the treatment of options expense in estimates, companies that include the cost in their own guidance may increase the likelihood that analysts' estimates also reflect the expense, thereby minimizing any confusion when reported earnings are compared to analysts' forecasts.

## Pro Forma Reporting and FAS 123(R)

The survey shows that many companies (about 46%) have not reported or do not plan to report pro forma earnings figures that exclude options expense. That is well above the 27% of respondents who said they have issued or plan to issue pro forma earnings results. The remainder (27%) did not know the answer to the question. **(Fig. 19)**

Since stock options are a non-cash expense, some observers have anticipated an increase in the reporting of pro forma earnings figures that exclude options expense, as more companies begin adopting FAS 123(R)<sup>2</sup>. Still, Thomson Financial's survey suggests that **more companies are currently not using or planning to use pro forma earnings metrics than companies who are.**

On a sectoral basis, **the heaviest user or planned user of pro forma earnings metrics excluding options expense was the technology sector.** A full 46% of all tech companies said they have issued or plan to issue pro forma earnings numbers that exclude options expense. The next heaviest users were the biotech (36%) and healthcare (33%) sectors. The lightest issuance or planned issuance of pro forma earnings figures was in the staples sector. Just 9% of staples companies said they reported or planned to report pro forma earnings figures that back out the expense. The energy (10%) and financial (14%) sectors were the next lightest users. **(Fig. 20)**

Based on market capitalization, **the biggest users or planned users of pro forma earnings metrics excluding options expense were small cap companies (43%),** while mega cap companies (18%) were the lightest users. **(Fig. 21)**

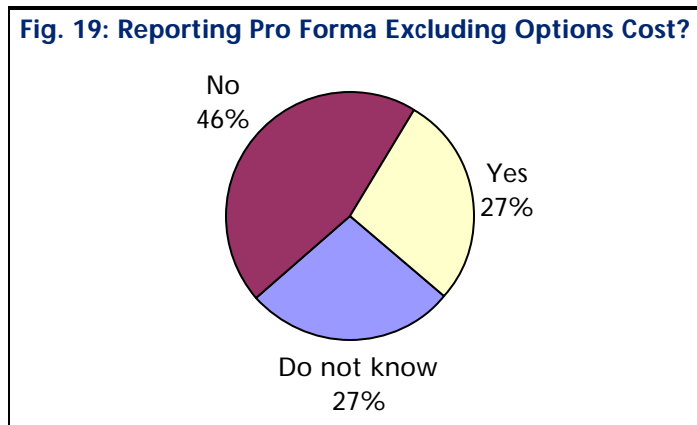


Fig. 20: Sector Use of Pro Forma Excluding Options Expense

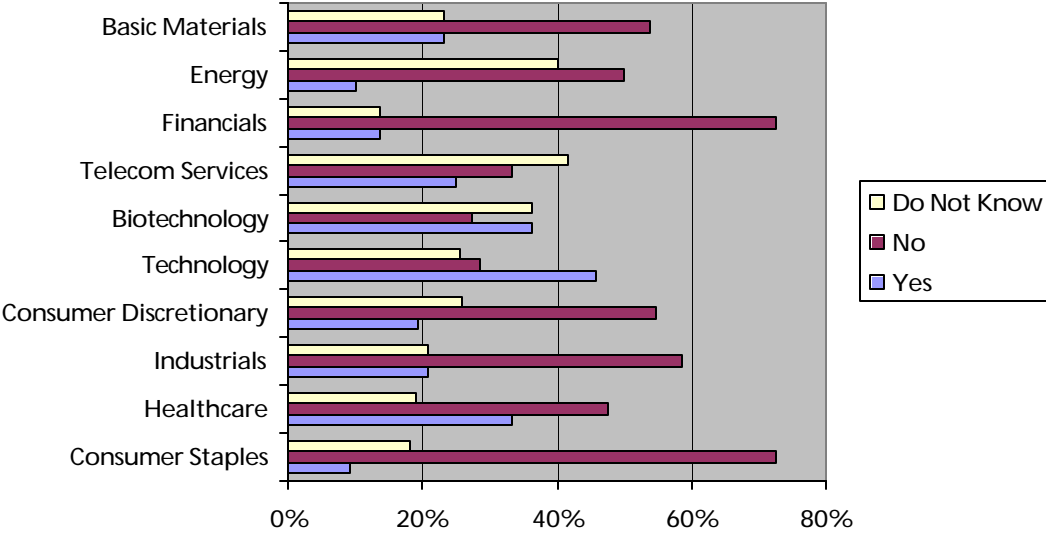
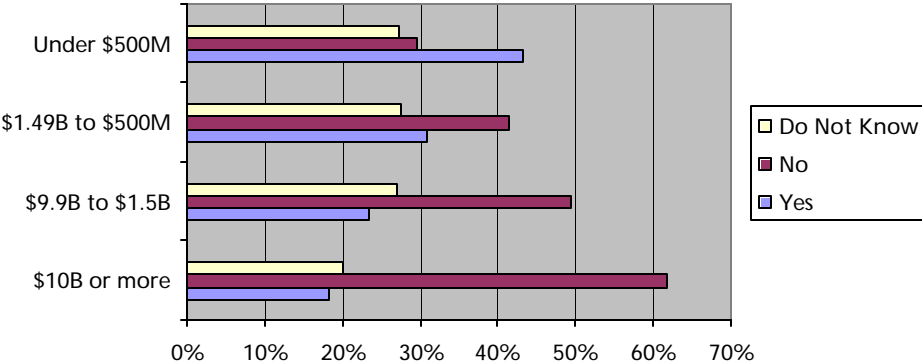


Fig. 21: Market Cap Use of Pro Forma Excluding Options Expense



## Companies Curbing Option Grants

A full 45% of respondents said they have curtailed or are planning to curtail the number of employee stock options granted as a result of FAS 123(R). That compares to 34% of companies that said they have not reduced or have no plans to reduce their option grants. (Fig. 22)

On an industry level, the technology sector appears to have the highest rate of companies (62%) that have reduced or are planning to reduce options granted, followed by the industrial (57%) and staples (55%) sectors. (Fig. 23) The tech sector's lead in this regard is not surprising given that tech companies have been known for awarding far more equity-based compensation than most other industries.

Meanwhile, the difference in grant reduction rates among companies with varying market capitalizations was relatively insignificant. (Fig. 24)

The move away from stock options as a major component of employee compensation has been reflected in other recent studies<sup>3</sup>. This trend has been an anticipated consequence of FAS 123(R), as companies seek to mitigate the rule's negative impact on their reported earnings.

Aside from cutting option grants, a number of companies have taken other steps to lower the amount of their options expense. For example, many companies have accelerated the vesting of their options. This practice involves moving up the vesting date of stock options outstanding so that their full compensation value is recognized before the effective date of FAS 123(R). As such, companies are able to recognize no compensation expense in their income statements for options that are underwater (the price employees could purchase stock by exercising them is above the current share price). However, for above-water options companies may face a large one-time charge.

Meanwhile, some companies have shortened the contractual life of their options in a bid to reduce options expense. The shorter the expected life, the less valuable the option and, therefore, the lower the expense.

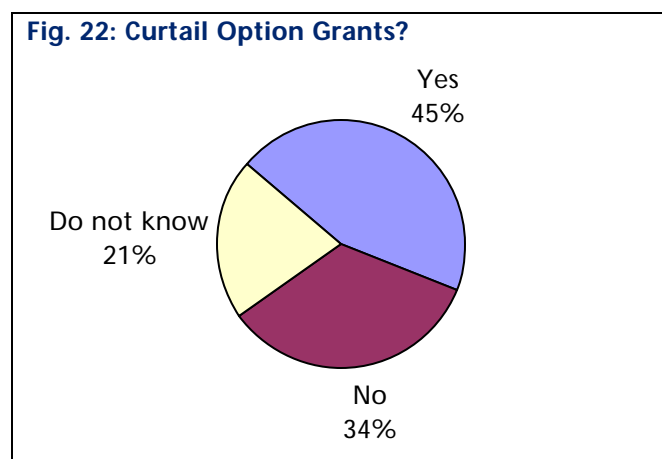


Fig. 23: Curbing Option Grants by Sector

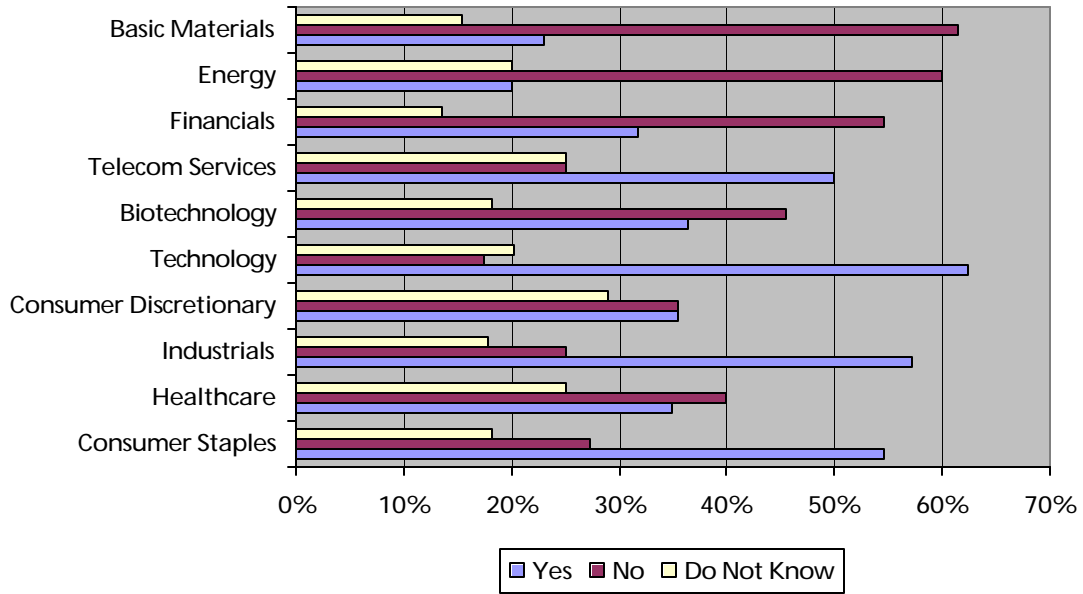
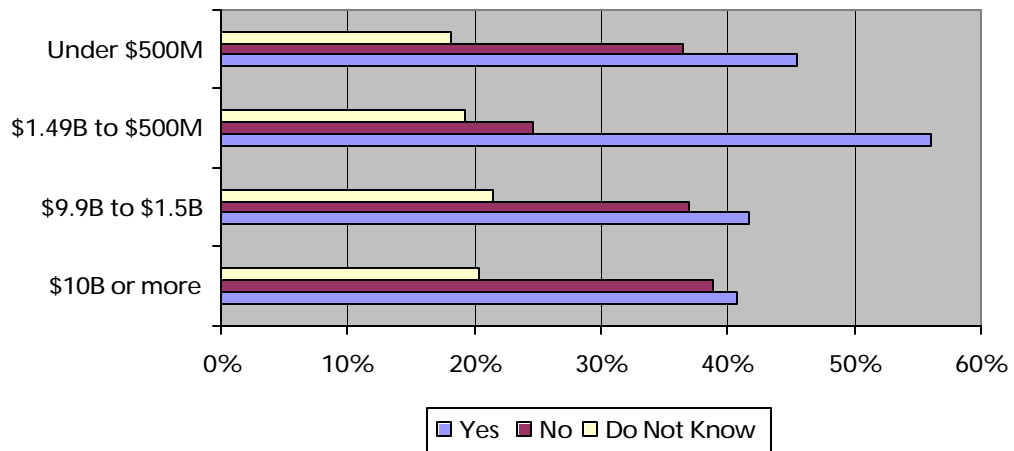


Fig. 24: Curbing Option Grants by Market Cap



### Restricted Stock Replacing Options

Most respondents (about 73%) that have curbed or are planning to curb their option grants said they are using or planning to use restricted stock/restricted stock units (time and/or performance-vested) to offset the reduction in options granted. (Fig. 25)

Further, time-vested restricted stock was a more popular choice than performance-vested restricted stock. A full 61% of respondents said they are using or planning to use time-vested restricted stock to offset the reduction in options granted, while 32% said they are using or planning to use performance-vested restricted stock.

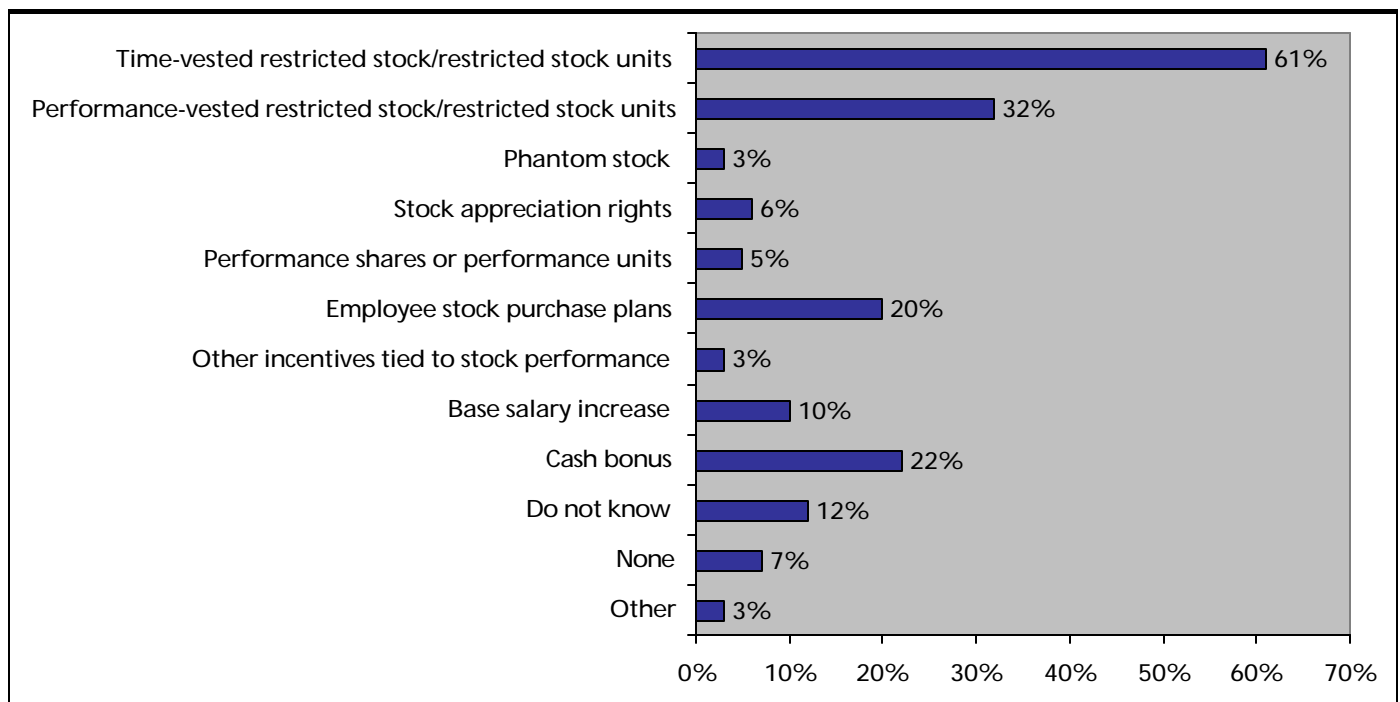
Cash bonus (22%) and employee stock purchase plans (20%) were the next most popular choices.

Only 7% of respondents said they have not or are not planning to shift to other forms of compensation.

The greatest concentration of respondents using or planning to use time-vested restricted stock was in the biotech sector (75%). Other big users of time-vested restricted stock were the cyclical (73%), financial (71%), staple (67%) and technology (67%) sectors. The lightest users were the basic material (33%) and telecom (33%) groups.

Meanwhile, the biotech, staple and energy sectors had the highest rate of companies using or planning to use performance-vested restricted stock. Half of the respondents in each of those industries said they are using or planning to use performance-vested restricted stock. The lowest rates of usage were in the financial (14%) and telecom (17%) sectors.

Fig. 25: Other Forms of Compensation



**Why Restricted Stock?**

Some critics have asserted that stock options may encourage executives to stress short-term gains over long-term strategy. As such, some institutional investors have pushed for increasing the use of restricted stock, which some consider to be a longer-term award, for retention and attraction of employees.

With restricted stock, employees receive a grant of stock that cannot be sold for a defined period of time. Unlike stock options, which allow the recipient to purchase shares at a fixed price, restricted stock costs the employee nothing and generally awards the employee even if the share price drops. Restricted stock may therefore have a higher perceived value for employees, making it a better retention tool, particularly during uncertain times when stock options could be underwater.

Still, restricted stock also has its critics. That is partly because a substantial portion of companies' restricted stock is time-vested rather than performance-vested. With time-vested shares, employees receive the value of the restricted stock simply by staying at the firm for the vesting period. No performance requirements need to be met. As such, employees make money even if the stock price goes down.

**Performance-Vested Shares May Gain Converts**

In a bid to further align management and shareholder objectives, companies are seen increasing the use of performance-vested restricted stock in their compensation programs. Performance-vested restricted stock is an enhancement of traditional restricted stock. Here participants are vested only if certain performance goals are met.

Another reason performance-vested restricted stock may gain in popularity is that the accounting treatment is more favorable than it was under prior rules. That is because restricted stock tied to performance metrics no longer needs to be marked to market each quarter, thanks to FAS 123(R)'s elimination of variable accounting for this type of stock award.

## Stock Impact

Most survey respondents (67%) said options expensing has not negatively impacted or they do not expect it to negatively impact their stock price. Just 9% said options expensing has hurt or they expect it to hurt their stock price, while a full 24% said they do not know. (Fig. 26)

On an industry level, the basic material, biotech and staples sectors had the highest incidence of companies (around 80%) say they do not expect options expensing to have a negative impact. Meanwhile, healthcare (24%), tech (16%) and industrial (14%) companies said most often that investors will react negatively to options expensing. The highest rate of uncertainty was in the tech, telecom and cyclical sectors. About 30% of respondents in each of those industries said they did not know the answer.

Uncertainty among a number of respondents about option expensing's impact could partly explain why so many companies have taken or plan to take steps to curb their option costs. Still, a number of companies that do not anticipate a stock impact have also cut or expressed an intention to cut their option grants.

Based on survey responses, some of the uncertainty over option expensing's impact on stock prices appears to stem from companies not knowing how analysts will treat option costs in valuing companies and how any inconsistencies in their valuation methods will play out in the market.

Meanwhile, some of the reasons respondents gave for why they believe their stock has been impacted or will be impacted were also related to sell-side estimates. Some said the majority of sell-side analysts covering them had not included options expense in their estimates, while analysts covering their peers had excluded the expense in their forecasts. Another reason cited was an expectation that some investors may not understand the impact of FAS123R adoption on reported earnings.

Among the large number of companies that said they have not seen or do not expect negative investor reaction to options expensing, a popular reason given was that their expense amounts were immaterial to their financial statements. This could be due in part to the widespread effort by companies in recent years to reduce option costs, by such means as cutting option grants and accelerating vesting schedules.

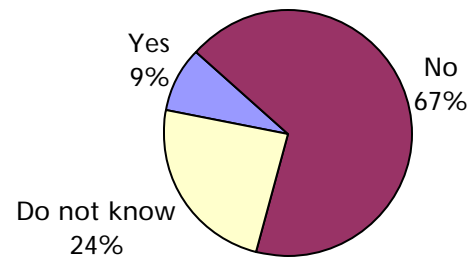
Other companies noted that options expense has been readily available to the financial community for years via financial statement footnotes in accordance with accounting rules predating FAS 123(R). As such, they deem any FAS 123(R) earnings impact to already be factored into stock prices.

Several respondents also cited a belief that institutional investors focus more on cash flow than reported earnings when making investment decisions. Since stock options are a non-cash expense, they do not impact cash flows.

No studies to date have found evidence that options expensing negatively impacts stock prices. A study led by a UCLA professor of 140 public companies that announced in 2002 and 2003 an intention to begin expensing options found that "there is no evidence whatsoever that expensing stock options reduces the stock price." On the contrary, the stock price tended to climb slightly, possibly as a reward for transparent reporting<sup>4</sup>.

In addition, a Deloitte survey conducted during the second quarter of 2005 found that 83% of respondents believed FAS 123(R) will have little to no impact on their stock price<sup>3</sup>.

Fig. 26: Negative impact on stock price?



## Expect Stock Impact?

### Do not know

*At this point, we're not sure how analysts will treat this in valuing our company...they may decide to back it out of their models. -- Small-cap energy company*

*In the short term, there will likely be confusion among estimates, with some including the expense and some not. -- Large-cap healthcare company*

### Yes

*Expect some negative reaction from some investors who may not understand the one-time impact of adoption on EPS trends. -- Large-cap healthcare company*

*Over time, GAAP earnings will properly be viewed as "real earnings" in tech. That, combined with the current multiple compression issue in the market place will result in lower stock prices. -- Large-cap technology company*

*The majority of our analysts have included stock option expense in our model. Therefore the prior year comparative financials show that EPS is lower this year than last year and the majority of our peers have not begun to expense stock options yet so our PE is lower as a result. -- Large-cap technology company*

*When we gave our first guidance that includes options, the majority of our analysts included the expense in their new estimates. Most of the other companies I have observed that have started to disclose options expense have still had a majority of their analysts exclude the expense from their models. Consequently, due to confusion and our estimates being adjusted more than our peers, I think our stock has been penalized. -- Large-cap technology company*

### No

*Stock option expense is not that material to our financial statements. -- Mega-cap energy company*

*Like the change in goodwill accounting, I expect the market to "look past" this accounting change. The figures have been available in footnotes for years already -- should not be any surprise that would impact valuation. -- Large-cap industrial company*

*I believe the sell-side will ignore it and use pro-forma. Our option expense numbers have been in our footnotes for a long time, so the sell-side is already familiar with the number. -- Small-cap technology company*

*Most investors and analysts are focusing on cash flows....earnings have become too nebulous with all the different fair-value accounting that companies are subject to which makes results less than comparative. -- Large-cap basic materials company*

*The cash flow impact to the company has not changed, regardless of whether equity comp is footnoted (formerly) or expensed to the P&L (current/going-forward). The P&L impact is not accurate relative to the cash flow impact (which is more important), due to the poor availability of models available to estimate the expense. -- Large-cap consumer staples company*

## Conclusion

Now that the fair value of employee stock options must be reflected in the income statement, companies face a flurry of new valuation, transition and guidance considerations, among others.

Despite the lattice pricing model's potential for enhanced valuation accuracy, most companies are sticking with or planning to use the Black-Scholes model, due to its ease of use and overwhelming popularity.

As for guidance, the majority of companies are opting to issue an earnings estimate that includes options expense. However, many of these companies indicated they are also providing an accompanying estimate that excludes the cost. Meanwhile, sell-side analysts are excluding options expense from their forecasts for a number of companies, resulting in inconsistencies in the way some companies and analysts approach the treatment of FAS 123(R) in estimates. Still, compared to companies that issue an earnings estimate that excludes options expense, or give two estimates (with and without the expense), companies that include the cost in their earnings forecast and do not provide an accompanying estimate excluding it, appear to have a higher prevalence of analyst estimates that include the expense.

Companies are also faced with the question of whether to post pro forma earnings that exclude options cost. While some on Wall Street have predicted FAS 123(R) will lead to an increase in the use of pro forma earnings metrics, most companies said they are either not reporting (or planning to report) pro forma earnings metrics excluding options expense, or are undecided on the issue.

On the issue of transition, the majority of companies appear to see little value in restating prior earnings to include options expense, instead choosing to adopt FAS 123(R) on a prospective basis only. Meanwhile, many companies, concerned about the impact of options expensing on their reported earnings, have been cutting their options grants and replacing them with restricted shares.

The aforementioned trends, namely in the areas of valuation, guidance and compensation practices, are sure to continue evolving long after the options-expensing transition period is over.

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## Notes

<sup>1</sup>AON Consulting. 2005. "Use of Binomial Models by Companies to Value Stock Options for FAS 123 Increases 40% Since 2003."

<sup>2</sup>Cohen, A., M. Moran, K. Shaustyuk. 2005. "Stock Option Expensing: The Battle Has Been Won; Now Comes the Aftermath."

<sup>3</sup>Deloitte. 2005. "Options Take a Hit, but What Will Take Their Place?"

<sup>4</sup>Elayan, F., K. Pukthuanthong, and R. Roll. 2005. "Investors Like Firms That Expense Employee Stock Options and

# Appendix

- A. **Survey Methodology**
- B. **Survey Questions, Percentage Responses and Selected Verbatims**
- C. **Questions and Answers About the New Accounting Rules for Stock Options: FAS 123(R)**

## Appendix A: Survey Methodology

The survey was conducted online between November 2 and November 9, 2005. Survey responses were drawn from 386 public companies representing most major industry sectors and market capitalizations. Some companies did not answer every question, and more than one answer was permitted from each respondent for select questions. Survey participation was voluntary and anonymous.

For questions concerning companies' and analysts' earnings estimates, it was assumed that the respondent was (or will be) required, in accordance with FAS 123(R), to recognize options expense in financial statements covering periods for which the estimate was (or will be) provided.

Also, the question related to the issuance of pro forma earnings assumed that the company was (or will be) required, in accordance with FAS 123(R), to recognize options expense in financial statements covering periods for which the earnings were (or will be) reported.

Market capitalization categories used in the survey were defined as follows:

Small cap: Under \$500 million  
Mid cap: \$1.49 billion to \$500 million  
Large cap: \$9.9 billion to \$1.5 billion  
Mega cap: \$10 billion or more

## Appendix B: Questions, Percentage Responses and Selected Verbatims

1. Does your company have an employee stock option program?

<b>Yes</b>	<b>93.8%</b>
No	6.2%

If yes, is your company currently expensing stock option compensation using FAS 123(R) accounting?

Yes	34.8%
<b>No</b>	<b>65.2%</b>

2. Which options pricing model is your company using?

<b>Black-Scholes model</b>	<b>70.9%</b>
Lattice model	12.6%
Do not know	15.5%
Other (please specify)	1.0%

Reason(s) your company is using the Black-Scholes model include: (please select all that apply)

<b>Perception that model is the most widely used by companies</b>	<b>56.6%</b>
Ease of use relative to other models	54.7%
Lower implementation costs than other models	24.5%
Expectation that model will yield a more accurate valuation than other models	22.6%
Expectation that model will yield a lower valuation than other models	1.9%
Options expense is NOT a significant part of company's financial statement	15.1%
Options expense is a significant part of company's financial statement	1.9%
Expectation that difference in values generated by various models is immaterial	20.8%
Limited available historical data on employee exercise price patterns	5.7%
Other (please specify)*	5.7%

\*Other included availability on Equity Edge software and consistency with prior footnote disclosure

Reason(s) your company is using a lattice model include: (please select all that apply)

Perception that model is the most widely used by companies	25.0%
Ease of use relative to other models	25.0%
Lower implementation costs than other models	12.5%
<b>Expectation that model will yield a more accurate valuation than other models</b>	<b>87.5%</b>
Expectation that model will yield a lower valuation than other models	25.0%
Options expense is NOT a significant part of company's financial statement	12.5%
Options expense is a significant part of company's financial statement	12.5%
Expectation that difference in values generated by various models is immaterial	12.5%
Limited available historical data on employee exercise price patterns	0.0%
Other (please specify)*	12.5%

\*Other included implied FASB preference at time of implementation

3. Does your company plan to switch to a different options pricing model in the future?

Yes	1.3%
<b>No</b>	<b>62.7%</b>
Do not know	36.0%

Which pricing model does your company plan to switch to?

N/A

4. If your company is NOT currently expensing stock options using FAS 123(R) accounting, which options pricing model does it plan to use?

<b>Black-Scholes model</b>	<b>60.0%</b>
Lattice model	9.2%
Do not know	30.8%
Other	0.0%

Reason(s) your company is planning to use Black-Scholes include: (please select all that apply)

Perception that model is the most widely used by companies	61.5%
<b>Ease of use relative to other models</b>	<b>76.9%</b>
Lower implementation costs than other models	51.9%
Expectation that model will yield a more accurate valuation than other models	11.5%
Expectation that model will yield a lower valuation than other models	1.9%
Options expense is NOT a significant part of company's financial statement	11.5%
Options expense is a significant part of company's financial statement	10.6%
Expectation that difference in values generated by various models is immaterial	40.4%
Limited available historical data on employee exercise price patterns	18.3%
Other (please specify)*	6.7%

\*Other reasons include consistency with method used for prior footnote disclosures, burden of having to justify an expected volatility rate and expectation that investors will ignore options expense.

Reason(s) your company is planning to use a lattice model include: (please select all that apply)

Perception that model is the most widely used by companies	16.7%
Ease of use relative to other models	8.3%
Lower implementation costs than other models	8.3%
<b>Expectation that model will yield a more accurate valuation than other models</b>	<b>91.7%</b>
Expectation that model will yield a lower valuation than other models	41.7%
Options expense is NOT a significant part of company's financial statement	0.0%
Options expense is a significant part of company's financial statement	41.7%
Expectation that difference in values generated by various models is immaterial	0.0%
Limited available historical data on employee exercise price patterns	0.0%
Other (please specify)*	8.3%

\*Other reasons include availability of historical data.

5. Has your company gone back or does it plan to go back and include options expense in prior year numbers?

Yes	13.5%
<b>No</b>	<b>52.1%</b>
Not applicable	6.0%
Do not know	28.4%

\*NOTE: Following starred questions assume that company was or will be required, in accordance with FAS 123(R), to recognize options expense in financial statements covering periods for which guidance was or will be provided.

6. Has your company included or does it plan to include options expense in its earnings guidance?\*

<b>Yes</b>	<b>58.4%</b>
No	13.2%
Not applicable	11.5%
Do not know	16.9%

7. Has your company provided or does it plan to provide both an earnings guidance number that includes options expense AND a number that excludes the expense for the same period?\*

<b>Yes</b>	<b>32.2%</b>
No	31.0%
Not applicable	9.7%
Do not know	27.1%

8. Prior to the introduction of FAS 123(R), did your company include options expense in earnings guidance for any period in which options expense was incurred?

Yes	9.1%
<b>No</b>	<b>72.8%</b>
Not applicable	10.6%
Do not know	7.5%

Please feel free to elaborate on any aspect of earnings guidance and options expensing.

*Our company did not provide guidance to the public.*

*We have been expensing stock options already and have not yet determined the impact of Fas 123(R).*

*We provide earnings guidance on pro forma EPS only.*

*It would be our preference to only issue GAAP guidance, but if other companies in our industry issue both we will do the same.*

*The guidance for the first year will include both option expense and a number that excludes it for the same period, for prior year comparison purposes. After year 1 of adoption, we plan simply to go with the expense that includes SOE.*

*Equity comp is a labor cost, and should be included in reported numbers and forward looking statements.*

*We expect to give guidance including option expense and also to give the option expense cost. We don't plan to give non-GAAP guidance excluding options expense.*

*We will most likely provide the earnings impact of options expensing included in our guidance rather than giving two numbers, one with and one without.*

*Our Company does not give earnings guidance. We do separately disclose historical expense and cost amounts related to our options and other stock based plans.*

*We adopted stock option expensing in guidance and reporting actual results for the year 2005. We did not re-state 2004 earnings, but provided investors with pro forma earnings statement by quarter including 2004 stock option expense.*

*Options expensing was previously a footnote item only. FAS123-R required expensing, as of the most recent quarter (for our company, based on our fiscal year), for ALL equity compensation (restricted stock, performance units), not just options expensing.*

*To the extent that guidance was quoted in Diluted Earnings Per Share, we gave guidance including options.*

*When we made the change with the implementation of IFRS standards for 2004 accounts (this is pursuing IFRS 2 and not FAS 132 as we are a European company), we provided the impact of this change, ie we provided figures with and without option expenses. For 2005 and onward we will only provide a guidance including this cost.*

*We plan to start expensing options beginning next February, which is the first quarter of our fiscal year. We are current reviewing all alternatives you mention in this survey. Kudos to Thomson for doing the survey because most of our discussions on expensing for options ends with a question . . . what is everybody else doing. This survey will be incredibly helpful.*

*We adopted FAS123 effective April, 2003, so we have been expensing all equity grants for several years ahead of the FAS123(R) requirement.*

*Not a significant number so minimal impact on guidance.*

*Prior to 123R we had performance based stock options that were required to be expensed. That expense was always factored into guidance.*

*Don't plan to recalculate options expense impact going backwards because the impact has been footnoted in our 10K reports.*

*We used variable accounting for equity based compensation.*

*We are waiting to see what the majority of other companies do before committing to a methodology or guidance process. My sense is that the analysts will be backing out the options expense in their estimates.*

*We provide very limited guidance, options expense is included.*

*We provide our earnings guidance excluding the impact of FAS 123(R) and then provide specific projected EPS and pre-tax income impact of FAS 123(R). In our actual reported results, we also do a with and without presentation, along with all the required Reg G disclosures (reconciliation, etc.).*

*Difficulty in currently predicting the use of options in future periods relative to past history. (esp. Board intentions and external competitive employment pressures.)*

*We have not made a decision whether to report earnings on a pro-forma basis that excludes stock option expense. Several companies have reported a line by line pro forma impact in the income stmt & balance sheet, we are considering doing the same.*

*Expensing was done prospectively and not significant to earnings.*

*Rather than pro forma information we give the value of stock options that we expect to be expensed as separate disclosure.*

*We do not provide earnings guidance but will provide an estimate of option expense under FAS 123R.*

*Our guidance includes the options expense, but we tell investors how much the options expense is.*

*We have not provided any 2006 earnings guidance. We will include the effect of expensing options within that guidance.*

*We're most likely going to provide guidance as usual: GAAP and non-GAAP. GAAP will include options expense and non-GAAP will exclude option expense.*

*Will include options expense in guidance starting in first quarter 2006 upon adoption.*

9. Roughly what percentage of sell-side analysts have NOT included options expense in their most recent estimates for your company? (NOTE: Question assumes that company was or will be required, in accordance with FAS 123(R), to expense options in the period for which estimates were provided.)

None	16.6%
1-20%	4.7%
21-40%	1.2%
41-60%	6.0%
61-80%	5.1%
81-100%	29.6%
Not applicable	4.4%
<b>Do not know</b>	<b>32.4%</b>

10. Has your company reported or does it plan to report pro forma financial results that exclude options expense for any period in which options expensing was or will be required in accordance with FAS 123(R)?

Yes	27.1%
<b>No</b>	<b>45.7%</b>
Do not know	27.2%

11. Has stock options expensing negatively impacted or do you expect it to negatively impact your company's stock price?

Yes	8.9%
<b>No</b>	<b>67.1%</b>
Do not know	24%

Why?

**Yes**

*Our company, because of the June year-end, was one of the first companies to adopt 123R, and as a result, there was some confusion. Different than your question above, we have reported financial results including stock compensation expensing for periods in which expensing was not required to provide comparable year to year information.*

*It hasn't affected us before, but we do think the stock will be impacted by stock option expensing.*

*Expect some negative reaction from some investors who may not understand the one-time impact of adoption on EPS trends.*

*Over time, GAAP earnings will properly be viewed as "real earnings" in tech. That, combined with the current multiple compression issue in the market place will result in lower stock prices.*

*Lower EPS, and the effect related to different industries and sizes of company which have utilized options to significantly different extents.*

*The majority of our analysts have included stock option expense in our model. Therefore the prior year comparative financials show that EPS is lower this year than last year and the majority of our peers have not begun to expense stock options yet so our PE is lower as a result.*

*It's hard to quantify, but we were one of the first companies to expense stock options (we have a June fiscal year end), and when we gave our first guidance that includes options, the majority of our analysts included the expense in their new estimates. Most of the other companies I have observed that have started to disclose options expense have still had a majority of their analysts exclude the expense from their models. Consequently, due to confusion and our estimates being adjusted more than our peers, I think our stock has been penalized.*

*Confusion.*

**No**

*Information is already disclosed in the notes therefore we do not expect it to have a significant impact on stock price.*

*It should be a non-factor for the educated investor. We've been disclosing it as a footnote in our financial statements, so most educated investors should already be aware of the impact.*

*All options vested (and underwater).*

*Most investors and analysts are focusing on cash flows....earnings have become too nebulous with all the different fair-value accounting that companies are subject to which make results less than comparative.*

*Our share price did not significantly change upon our first disclosure of option costs. Most likely, this is because stock option expense is not that material to our financial statements.*

*Not a material number, will account for a few cents per share.*

*We adopted stock option expensing as of January 1, 2005. Our expense was comparable in 2004 and 2005, so our earnings growth was the same with or without expensing options.*

*The cash flow impact to the company has not changed, regardless of whether equity comp is footnoted (formerly) or expensed to the P&L (current/going-forward). The P&L impact is not accurate relative to the cash flow impact (which is more important), due to the poor availability of models available to estimate the expense. Investors have seen through these issues, recognizing the true value of the company hasn't changed, regardless of how you account for these items.*

*Immaterial relative to our competitors.*

*While we have not yet adopted FAS 123(R) we do provide proforma information in our 10Q & 10K filings that show the impact on earnings if we had already adopted it. Thus far, adopting FAS 123(R) would had a negligible impact on earnings.*

*As it is a non cash expense, it does not affect our ability to generate strong cash flows.*

*Was previously charged to operating unit and reversed on a corporate level.*

*Options expected in our market sector, whereas earnings are not. Therefore figures including option expense generally ignored by analysts.*

*The street is not stupid. They understand the financial implications of the options we currently have outstanding.*

*Because we have been expensing options for 2+ years, we believe 123(R) will not negatively impact our stock price. In fact, we believe 123(R) will have a positive impact as it forces all firms to a "level" field.*

*Option program is available to employees at or below the manager level only. The amount of potential stock issuance is minimal. Senior management receive shares - not options - based on a formula that compares the company's TSR to the overall market.*

*Like the change in goodwill accounting, expect market to "look past" this accounting change. The figures have been available in footnotes for years already -- should not be any surprises that would impact valuation. I've heard otherwise from sell-side analysts, but find the argument difficult to comprehend.*

*I believe the sell-side will ignore it and use pro-forma. Our option expense numbers have been in our footnotes for a long time, so the sell-side is already familiar with the number.*

*It doesn't change cash flow.*

*Options were previously reported in the footnotes (No. 25) and the market is efficient enough to correctly value the stock despite not showing up in reported EPS.*

*We have already started expensing options and we have a small overhang.*

*It is not a significant number.*

*It is non-sense and most know that it is non-sense- Earning no part of what is most watched about us at this stage.*

*The effective cost of options has been built into the price - soon, all firms will be on equal footing.*

*Our earnings and sales growth were high enough to out weigh the impact of options this quarter. The bulk of options vested this quarter and expense going forward will not be significant.*

*Non-cash charge. Plus, there are so many ways to change the results by manipulating the assumptions that drive the results. Apples to apples is next to impossible to arrive at when comparing two like companies.*

*Although not included in EPS in the past, we have disclosed in footnote form the amount of the EPS impact if FAS 123R had been applicable.*

*Pro-forma reporting will exclude the expense for all competitors.*

*It's always been reported. Making it GAAP should not change the nature of the 'expense.'*

*This EPS impact does not change the fundamental cash flow performance of the company.*

*Sounds like most software investors at this point are planning to EXCLUDE option expense for purposes of valuation. Also, we are planning to reduce the size of our grant a little resulting in (1) smaller option expense and (2) burn rate that's more in line w/the industry norm.*

*Multiples will readjust.*

**Do not know**

*At this point, we're not sure how analysts will treat this in valuing our company...they may decide to back it out of their models.*

*Too many other factors affecting the price to know at this stage.*

*This is not unique situation for any one public company. Larger cap companies will have an advantage over smaller cap companies because they can spread the expense over more shares to minimize the impact to EPS. The same thing can be said about any expense and is, therefore true today before expensing for options. This makes a strong argument for small cap companies to restate previous years to include option expenses so that their historical comparisons are more comparable. At the end of the day, this is a non-cash accounting change that doesn't truly change the valuation of a company, but the portfolio managers will decide once FAS 123(R) is adopted.*

*Believe it will slowly impact over time as P/E multiples for tech industry reflect stock option expense. In the short term, there will likely be confusion among estimates, with some including the expense and some not.*

*Because the expense will impact earnings, our valuation may be negatively affected because less income multiplied by a common industry multiple yields a lower valuation, despite efforts to remind investors of the year-over-year differences.*

*Impact is approximately 10% of net income, which we believe is acceptable to stock holders given the company's growth rate of sales and earnings.*

12. Has your company curtailed or does it plan to curtail the number of options granted as a result of FAS 123(R)?

<b>Yes</b>	<b>45%</b>
No	33.9%
Do not know	21.1%

Which additional methods of compensation, if any, is your company using or planning to use to offset the reduction in options granted?

<b>Time-vested restricted stock/restricted stock units</b>	<b>61.1%</b>
Performance-vested restricted stock/restricted stock units	31.9%
Phantom stock	2.7%
Stock appreciation rights	6.2%
Performance shares or performance units	5.3%
Employee stock purchase plans	19.5%
Other incentives tied to stock performance	2.7%
Base salary increase	9.7%
Cash bonus	22.1%
Do not know	11.5%
None	7.1%
Other	2.7%

Please feel free to elaborate on any aspect of FAS 123(R) implementation.

*FAS 123(R) had a minimum impact to our company due to the fact there are almost zero options outstanding. Majority of our stock grants have been in the form of RSU's.*

*It is a very, very complex implementation that is still in the process of being understood by most companies, including the major audit firms. The FASB's rules do not appear to be completely thought out and are surprisingly difficult to interpret.*

*Surprisingly Canada led the US on this. It is a major pain as everyone tries to use a "fair value" that results in the lowest expense, consequently, results between companies are less comparable than ever and investors, as usual, are poorly served by all the accounting "enhancements"*

*This pronouncement has it wrong. Options should not be expensed until options are exercised. No value is realized until options are exercised. It is not right to expense options that will never be exercised.*

*Implementation of FAS 123(R) was a very intensive effort. The rules tend to make option expensing more complicated than it needs to be. Complications and difficulty around valuation is acceptable. Complicating the reporting elements (pro-forma, non-pro-forma, APIC pool, forfeitures) borders on the ridiculous.*

*Options are an expense or you dilute your shareholders.*

*Our company accelerated the vesting of the out-of-the money options to reduce the impact of expensing options when we are required to do so starting in 2006.*

*This will hurt the competitiveness of U.S. technology companies versus foreign-based companies without the same accounting rules. We are, today, losing people in India and China because they can get stock options from the local companies.*

*Our stock price has risen quite rapidly and FAS123R is less volatile than variable accounting treatment.*

*The policy renders the income statement and earnings as a number that becomes unuseable as a metric for investors to follow. The swings of share price should not effect earnings. Might be a great idea in a back room some where of accounting theory but in the real world the concept is completely a stuff - up.*

*The standard is entirely appropriate and firms should learn to live with it. Options DO carry a cost to shareholders.*

*Very costly to implement and the individual investor will be more confused than ever.*

*1. We're using more of a combination of restricted stock and options going forward. 2. We'll be interested to see if the sell-side presents estimates/models in a consistent manner. Some may break out option expense, others may not, creating more variability in the range of estimates.*

*The most difficult FASB standard to implement since pension accounting! Too many grey areas to implement correctly!*

## Appendix C: Questions and Answers About the New Accounting Rules for Stock Options: FAS 123(R)

David E. Hardesty

David Hardesty is the author of Share-Based Payments: An Analysis of FASB Statement 123(R), published by Warren Gorham & Lamont.

### What is FAS 123(R)?

FAS 123(R) is a new accounting rule that must be followed by all companies, both public and private, to account for compensation paid in the form of "share-based payments." A share-based payment is any kind of payment that is ultimately based on a company's shares. The best known examples are stock options, stock appreciation rights, and restricted stock. Public companies that are not classified as small business companies have to start using the new rules for their fiscal years beginning after June 15, 2005; and other public companies begin using the new rules for their fiscal years beginning after December 15, 2005.

### What are the basic requirements of the new rule?

FAS123(R) requires companies to account for share-based payments (stock options, restricted stock, and similar instruments) using the fair value method. For employee stock options classified as equity instruments, this means that on the date the options are granted the company has to determine what the "market" would pay for the options. The company then recognizes this market value (fair value) as compensation cost as employees perform services to earn the options. No further compensation is recognized once employees have earned the options, unless the options are modified.

For example, Entity X awards Jones 1,000 options Jan. 1, 2006, to acquire Entity X common stock. On that date, each option has a fair value of \$10. Jones must remain an employee of Entity X for three years to exercise the options. Under FAS 123(R), Entity X recognizes \$10,000 of compensation cost ratably over the three-year service period-if Jones remains with the company. If Jones

leaves before vesting in the shares, and loses all of the options, Entity X recognizes no compensation cost. If Entity X has recognized a portion of the compensation cost prior to Jones' departure, then it must reverse that cost. If, after vesting, Jones decides not to exercise the options, such as when the options are under water, compensation is not affected. That is, the company recognizes the same amount of compensation cost regardless of whether the options are ever exercised, as long as Jones performs the required services and the options vest.

The above discussion relates to stock options. Another kind of share-based payment is a share appreciation right. Share appreciation rights that are settled in cash (i.e., the employee receives cash when he or she exercises the rights) are revalued at each reporting period, and the change in value is recognized as compensation in that period. Compensation cost in connection with share appreciation rights continues to be recognized until the rights are exercised or expire.

An issuer treats compensation cost recognized under the fair value method the same as cash compensation. That is, compensation cost arising from the issuance of stock options may be expensed or capitalized in the same way as cash compensation. Compensation cost is offset by an entry to paid-in capital. When a holder exercises options the issuer transfers a portion of paid-in capital to its outstanding stock account, but does not recognize any additional compensation cost.

The issuer ordinarily will receive a tax benefit from the issuance and exercise of stock options, and must estimate and account for that benefit in the same period that it recognizes compensation cost for financial reporting purposes. Until the actual tax benefit is known, the amount of accrued benefit (deferred tax asset) is based on the amount of compensation cost recognized for financial reporting purposes. Once the amount is known, an adjustment is made to match the accrued benefit to the actual benefit. For example, if an issuer recognizes \$10,000 of compensation cost in connection with the issuance of an option, and the issuer's tax rate is 35 percent, the issuer accrues a deferred tax asset of \$3,500, and increases income with an associated tax benefit. The deferred tax asset remains on the books until the option is settled. The actual tax benefit, in most

cases, will differ from the deferred tax asset. If the actual tax benefit is higher, then the difference is ordinarily recorded as additional paid-in capital. If lower, then the difference is either a reduction of paid-in capital or a current period expense (the determination of whether there is an additional expense or not is based on specific rules set out in FAS 123(R)).

### How does accounting under FAS 123(R) differ from what companies have been doing?

Companies that have not previously adopted FAS 123, the predecessor of FAS 123(R), have accounted for share-based payments using the "intrinsic method." Under the intrinsic method the issuer of stock options recognizes compensation costs equal to the difference between the option exercise price and the value of the underlying stock. If, as is often the case, options are issued with an exercise price equal to the value of the stock, then no compensation is recognized when the options are issued. However, companies that use the intrinsic method must disclose in financial statement footnotes pro forma earnings, calculated as if the company had accounted for options using fair value. Under FAS 123 companies could voluntarily account for share-based payments in the body of their financial statements; and, as indicated below, many large companies have done so.

Here is an example of the difference in accounting for stock options using intrinsic value, and fair value.

Illustration: On January 1, 2006, Entity X issues to Jones, its president, 100,000 options to purchase Entity X stock, at a price of \$25 per share, at a time when the stock is trading at \$25. The options are fully vested, meaning Jones does not have to provide further services to retain these options. Assume Jones can exercise the options only on January 1, 2011. Also assume Entity X stock pays a 3% dividend, and that the risk-free interest rate is 2.5%. Finally, assume that the volatility of Entity X stock is 35% per year. The intrinsic value of these options (i.e., the excess of the stock price over the exercise price) is \$0, and Entity X recognizes no immediate compensation in connection with the issuance of these options under the intrinsic method. The fair value of these options, however, is \$6.36 per share option, using the Black-Scholes-Merton option-pricing formula; and the value is \$6.67

using a binomial lattice option-pricing model. Therefore, depending on the option pricing model used, compensation cost based on the fair value of the award is either \$636,000 or \$667,000. (See Question 5 for a discussion the calculation of fair value.)

### Which companies are most affected by the new rules?

FAS 123(R) is likely to hit smaller companies the hardest - especially small technology companies that make heavy use of options. As a group, companies in the S&P 500 will be least affected. The reason is, many of the companies in the S&P 500 have already adopted FAS123, which is the predecessor to FAS 123(R). As early as February 2004, 483 public companies had adopted FAS 123. 113 of these companies represented 41 percent of the S&P 500 index, based on market capitalization. As of June 2005, around 800 companies were accounting for share-based payments under FAS 123. Smaller companies, however, have not been adopters of FAS 123. These companies, which often make heavy use of stock options, will likely see earnings per share drop.

### What is "fair value" and how is it calculated?

Fair value is the amount the market is willing to pay for an instrument, such as a stock option, issued under a share-based payment plan. Because in almost all cases such instruments are never traded, fair value has to be estimated. In the case of stock options or share appreciation rights a company ordinarily estimates the value of such instruments using an option pricing model, such as the Black-Scholes-Merton model or a binomial lattice. Both of these pricing models estimate fair value using six factors-stock price, exercise price, volatility, risk-free interest rate, dividends and option term-that interact to create value.

- The stock price and option exercise price combine to create the **intrinsic value** of an option. For example, if the stock price is \$110 and the option exercise price is \$100, the intrinsic value is \$10, which is the minimum value of the option.
- The **risk-free interest rate** is the benefit received for owning rights in stock without having to pay cash to purchase the stock. If, for example, an individual holds an option to purchase stock, then the holder controls

that stock without having to pay cash to buy it. The option confers upon the holder a benefit equal to the risk-free interest rate on the cash saved.

- **Stock volatility** has value to an option holder because the holder benefits from stock increases without being hurt by stock decreases. For example, if a holder can buy stock at a price of \$13, and the stock price varies between \$8 and \$18, the holder can earn \$5, and cannot lose anything.

- A **dividend** paid on optioned stock is a reduction of option value, if the option holder does not receive the dividend.

- The longer the **term** of an option the more valuable it is. A longer term increases the benefit from control of the stock, and increases the chances of profiting from stock volatility.

Option pricing formulas, such as Black-Scholes-Merton or the binomial lattice, combine the values associated with the above factors to calculate fair value, using sophisticated mathematics. Until recently most public companies used Black-Scholes-Merton. However, the binomial lattice is gaining popularity among pricing experts because of its superior ability to account for unique factors of employee stock options, such as vesting periods and early exercise of options.

#### Where do companies get the data for calculating fair value?

For stock options issued to employees, most of the information required to calculate the fair value of a stock option or stock appreciation right is company specific, derived from analysis of trades in company stock. The two key pieces of information are stock volatility and the expected term of the option or SAR.

**Stock volatility.** Companies with actively traded stock will determine volatility using two methods. First, they will calculate volatility based on the historical pricing of their own stock. Note, however, that an option pricing model incorporates "expected volatility" in pricing an instrument. This means a company has to estimate what the future volatility of its stock will be. Sometimes historical data is a good predictor of future volatility, and sometimes it is not.

Second, if they have traded options or similar instruments in the market, they can use the volatility implicit in those instruments. When traders buy and sell options they calculate options using the same factors that a company uses to price options issued to employees. One of the factors used to price traded options is stock volatility. If a company's options are actively traded, then the volatility used by traders to price traded options can be used to value options issued to employees.

If a company's stock does not have a long trading history, then the company can use trading history of a basket of similar companies as a proxy for the expected volatility of its own stock.

**Expected term.** As noted above, the second key item needed to value an option or SAR is the expected term of the instrument. Because, all other things being equal, an option increases in fair value as its expected term increases, it is critically important to estimate when employee options will be exercised. Most employee stock options are issued with a ten year term, but are often exercised long before they expire. Recent academic research indicates that, on average, options are exercised a little over two years after they vest and more than four years before they expire. However, it may be difficult to come up with a good estimate for a specific company. For this reason the Securities and Exchange Commission allows companies to use a "safe harbor" expected term in pricing its options or SARs. The safe harbor formula is  $\text{Expected term} = (\text{vesting period} + \text{original contractual term}) / 2$ . For example, if an option is issued with an original term of ten years, and is subject to three-year vesting, the safe harbor expected term is 6.5 years  $( (10 + 3) / 2 )$ .

#### What should a company do if it cannot determine the fair value of options?

The Financial Accounting Standards Board (FASB), which issued FAS 123(R), expects that it will be rare that a company cannot arrive at a reasonable estimate of the fair value of options issued to employees. However, when this does happen, the company will use intrinsic value instead of fair value to account for its options.

### What are the accepted option pricing models?

There are a number of models that can be used to calculate the fair value of stock options and stock appreciation rights. The most popular, by far, is Black-Scholes-Merton, or BSM. BSM incorporates the six factors used to value options, discussed in Question 6, in an easy-to-use formula, the result of which is the fair value of the option. One of the reasons BSM is used by most companies is it is one of the formulas often used to price options that are traded in the market.

A method that is gaining in popularity is the binomial lattice (BL). Despite its obscure name the BL is conceptually easy to understand. Essentially, the BL uses the expected stock volatility and option term to estimate a range of future stock values. The estimated range of stock values gives an estimated range of option values (i.e., expected stock value less option exercise price), and this range of options value is averaged and discounted back to the option grant date, using the risk-free interest rate.

Given the same assumptions, both BSM and BL will give a similar option fair value, since the "underlying" mathematics of the two models are similar. However, the BL more easily accounts for certain factors unique to employee stock options, such as early exercise, vesting periods, black-out periods, and changing interest and dividend rates. For this reason the BL has the potential of giving a better answer than BSM.

When it wrote FAS 123(R) the FASB highlighted the use of the BL in its many examples of the calculation of fair value. However, the FASB did not recommend a particular model. The SEC has provided guidance on the implementation of FAS 123(R). In this guidance the SEC does not give preference to any particular model.

When calculating the fair value of options companies should test the use of more than one option pricing model. As noted above, two popular models, Black-Scholes-Merton and the binomial lattice produce similar results, given the same assumptions. However, using different models will likely cause a company to reevaluate the assumptions used. The binomial lattice is especially useful in this regard because it allows a company to see the effects of each assumption.

### Should prior years be restated?

FAS 123(R) does not require companies to restate prior year earnings for the effect of stock options. The new rules require companies to account for stock options only after the effective date of the new rules. However, public companies can restate prior years if they want to. Restating means historical earnings will be reported as if FAS 123(R) had been adopted in earlier years. This facilitates a comparison of current to previous earnings. There is no indication of how many companies plan to restate earnings. A company whose current earnings will be dramatically affected by FAS 123(R) may want to restate earnings to more clearly demonstrate to analysts earnings trends.

### How will stock prices be affected by the adoption of FAS 123(R)?

So far, there is no reliable empirical evidence of the effect of FAS 123(R) on future stock prices. For heavy users of stock options reported earnings will obviously decrease - in some cases dramatically. However, sophisticated investors may discount these drops in earnings. Those who follow companies that are heavy issuers of employee options have already taken into account the effect of options, since these companies have been required to report, in footnotes, the effect of stock options. In addition, many institutional investors pay more attention to cash flow than to reported earnings, so a drop in earnings may have little effect on investment decisions.

### Why are some companies accelerating the vesting of their options?

Some companies are accelerating the vesting of options, so that options are earned before FAS 123(R) becomes effective. Under FAS 123(R), a company has to recognize compensation cost associated with any nonvested options still outstanding when the new rules become effective. After the effective date companies must begin recognizing compensation cost for any nonvested options, as those options vest. Some companies are modifying options to allow them to vest early, so that no further compensation is recognized when the rules become effective.

**Why are some companies switching from stock options to restricted stock as a form of employee compensation?**

There are at least two reasons for this. The first is, employees in some companies are beginning to demand stock instead of stock options, because stock always has a value. Compare this to stock options, which have no value to the employee if the options are under water. Another reason is the difficulty in valuing and accounting for stock options, and providing all of the necessary disclosures associated with outstanding options. Stock options valuation is uncertain, and companies are uncomfortable with the amount of work involved in accounting for these options. Restricted stock, on the other hand, is quite easy to value, and requires minimal disclosures.

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