

### Overview

You will already be well aware that the Financial Accounting Standards Board's SFAS 123R, *Share-Based Payment*, goes into effect as of the beginning of the first interim or annual reporting period that begins after June 15, 2005 for most public issuers. For companies with calendar years, this effectively means January 1, 2006. SFAS 123R changes the method by which corporations account for options-based compensation to the fair value method from the intrinsic value method imposed under APB Opinion No. 25. Corporations must now recognize equity-based compensation costs and liability over the period during which an employee is required to provide service in exchange for the equity award (generally the vesting period) based on the fair value of the award as of the grant date, with the grant-date fair value to be determined using option-pricing models "adjusted for the unique characteristics of those instruments".

### Implications

FASB's intention was to more fairly measure the true cost of compensation to address investor concerns, simplify GAAP, improve financial statement comparability and conform to converging international accounting standards. However, this accounting change has created some financial and communications disconnects:

- The rule under GAAP states that issuers must book option-relations expense and liability. However, the method by which corporations arrive at these expense and liability estimates is murky because of the uncertainty inherent in the number of options granted, the service (vesting) period of the employees to whom options are granted, and the possible range of inputs used in the options pricing model to determine fair value. An issuer's stock price alone creates tremendous unpredictability in estimating option-based compensation expense.
- SFAS 123R does impact large-cap companies in sectors historically thought of as growth industries that have relied heavily on options grants as a form of compensation (thereby begetting the rule change). Witness Microsoft, the perennial test case, whose consensus earnings estimates for fiscal 2006 are gradually being decreased by roughly 10% on average per analyst to account for options expense, with the stock taking the attendant haircut in valuation.
- However, the rule change disproportionately penalizes micro- and small-cap companies in all sectors who have used options as a compensation practice. An option granted by a company with a \$200 million revenue base must be expensed in a manner identical to the same option granted by a company with a \$20 billion revenue base, and the valuation impact for smaller cap companies is therefore even greater.

### Getting Around the Issue

Many issuers have been attempting to avoid some of the impact on GAAP financials by:

- Providing supplemental non-GAAP pro forma or cash earnings along with GAAP quarterly results that exclude variable equity-based compensation expense
- Accelerating the option vesting period to reduce future expense and liability; this really only applies to out-of-the-money options grants
- Quantifying the pre-tax dollar and after-tax per share amounts of the option expense component of total expense in quarterly results releases in addition to GAAP reporting.

The last choice may be preferable to corporate auditors who adhere to the SEC's dislike of non-GAAP measures; however, this remedy is more difficult to achieve in organizations with complex p&l structures in which not all compensation expense is located on the SG&A line.

In addition, the complexity in arriving upon reliable estimates for option expense and liability, which essentially forces a company to forecast its own stock price, has caused some companies to consider changing their existing practice of issuing forward-looking guidance, in some cases pulling back on giving guidance altogether. Others have opted to offer guidance on the above-mentioned non-GAAP measures, or on operations only to a given p&l line, leaving the options expense forecasting exercise to analysts and investors.

Mystifying the issue further, there is as yet no coherent rule among Wall Street research firms governing inclusion or omission of options expense in analysts' estimates. Some firms such as *Merrill Lynch*, *UBS*, and *Bear Stearns* have created policies requiring analysts to include this expense in the models they submit to First Call, but even some of these permit revision if the expense causes the estimates to be excluded from the consensus metrics.

### **LHA Recommendation**

As calendar-year issuers adopt SFAS 123R throughout the next six to nine months, the issues of valuation inflation and stock price adjustments will sort themselves out as the playing field levels for all public companies. In choosing among the range of disclosure and communications options, we recommend the following:

- *Communicating impact on quarterly results.* In assessing whether to offer a non-GAAP measure or a quantification of options expense to supplement quarterly results, we will help you examine your own past communications practices and style, think through the degree and the complexity of option expense impact on your quarterly results, determine how similar companies and your peers are handling the issue, and evaluate the recommendation of your auditor. The objective of this exercise, as always, is to arrive upon a solution that elucidates your financial statements in a consistently credible manner.
- *Guidance.* SFAS 123R should not, in our minds, be used as a justification to cease giving guidance; halting this practice because of an issue that is common to all companies will only inject more uncertainty into your relationship with analysts and investors, increase stock price volatility, widen the range of consensus estimates, and threaten to disconnect the issuer's valuation from its peer set, particularly if the peer set maintains giving guidance. We can work with you to help adjust your existing guidance practices to incorporate the burden of options expense forecasting (or avoid it) in as simple a manner as possible.

As always, your LHA team is ready to help you sift through this and other issues as part of an effective investor relations program.