FINANCE & ACCOUNTING VIEW

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FAS 123(R) RAISES ISSUES FOR PRIVATE COMPANIES CONSIDERING PUBLIC OFFERINGS

The Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 123 (revised) takes effect for most companies this year, and its impact on executive compensation may be of particular interest to private companies planning an initial public offering of stock. Most notably, the new standard is expected to trigger changes in the valuation approach they use, which could result in a substantial increase in compensation expense.

FAS 123(R) generally requires private companies to expense stock options and other equity-based compensation arrangements beginning this year. It also results in more awards being classified as liabilities rather than included in equity. The new rules apply not only to newly granted awards, but to existing awards not fully vested and existing awards that are changed, repurchased or cancelled on or after the start of fiscal 2006.

"Previously, most companies did not expense options on the income statement, showing them only as a pro forma disclosure instead," says Scott Levy, practice leader for the New York area, NY assurance practice at Grant Thornton LLP. "Now they will have to be expensed on the face of the income statement. Depending on the number of options issued and the fair value assigned to them, it can have a material effect on a company's net income. How will investors view this? How will it influence the market price of the stock? These are important questions," Levy adds.

VALUATION CHALLENGES

There are several valuation-related challenges FAS 123(R) raises for private companies, says Susan Roos, a partner with PricewaterhouseCoopers LLP. "Companies can choose from several valuation methods, although most use the Black-Scholes model. But often it is not the method that presents the problem, but the input," she explains.

The main inputs for a Black-Scholes calculation are exercise or strike price, current fair value of the underlying common stock, risk-free interest rate, dividends (usually zero for private companies), volatility and time to expiration (or estimated time to exercise).

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Because most private companies have only had sales of preferred stock, arriving at an arm's-length valuation of their common stock can be difficult, Roos notes. Some turn to an outside valuation expert, while others make it an in-house endeavor. "This is an issue whether they are considering going public or not, but any company going through an IPO can expect to get more scrutiny," she says.

"In addition to the share prices, the value of an option is significantly influenced by the volatility of the underlying common stock and the time-value of the option itself," Roos says, offering the hypothetical example of a $20 at-the-money option (exercise price same as current price) with a 10-year term, 80% volatility and risk-free interest rate of 4%.

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“The intrinsic value charge in this example is zero, because there’s no difference between the prices. Under the old rules, the company would not have to take a charge. With Black-Scholes it is $16.65 per share, and if you change the volatility to 100%—for companies in the technology sector, volatility averages between 80% and 120%—it goes up over $18. However, if you were able to cut the time in half, to five years, it would only be $13,” Roos explains.

COMPENSATION CHARGES

One aspect of FAS 123(R) that should be advantageous to private companies is that it results in compensation charges being recorded more accurately, both Levy and Roos point out. “It requires all entities to recognize the fair value of share-based payment awards classified in equity, unless they are unable to reasonably estimate the fair value of the awards for one of two reasons,” Levy explains.

One reason is if a company cannot reasonably estimate the volatility of its share price. In that case, it is required to use historic volatility of an appropriate industry sector, and the result is known as calculated value rather than fair value. The second reason is if the complexity of an award’s terms prevents a company from reasonably estimating its fair value. The award is then valued at intrinsic value and variable accounting must be used.

TAX-ACCOUNTING IMPLICATIONS

Roos cautions that the tax-accounting implications of FAS 123(R) should not be overlooked. “People have focused on the valuation issue and the charge to be taken, but most don’t realize it can be very complex from a tax-accounting perspective. There is detailed recordkeeping that needs to be done going forward, and re-creation of past recordkeeping may be required in some cases,” she warns. “The other thing to keep in mind is that forfeitures play a very big role in the calculations and financial reporting, so make sure you consider them carefully and have the required recordkeeping for them.”

Levy and Roos both stress the importance of taking steps to begin dealing with FAS 123(R) issues right away. “Don’t wait until the fourth quarter of 2006,” Roos says. Adds Levy, “I strongly encourage companies to discuss stock option issues with professionals who have significant experience in this area. If it is not a standard option, consultation should be made to understand the accounting implications.”

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