

EXAMPLE OF A PERFORMANCE-BASED, VARIABLE ACCOUNTING STOCK OPTION PLAN

Figure 1

Facts

- 10,000 10-year options granted on Jan. 1, 2000, at an exercise price of \$50
- The stock price at Jan. 1, 2000, is \$50
- The stock price on Dec. 31, 2003, is \$66
- Assume that all options will vest
- Furthermore, options are earned based on the increase in the company's market share

Increase by 12/31/03	Options earned
5%	1,000
10%	3,000
15%	6,000
20%	10,000

Result Under APB 25

In this example, the number of shares that will ultimately vest to an executive is unknown at the date of grant. Because this variable cannot be determined, variable accounting is triggered, and the company is required to initially estimate the projected performance over the three-year period and to ultimately recognize the compensation expense. This amount should be equal to the number of options earned multiplied by the difference between the exercise price and the stock price at the conclusion of the three-year performance plan cycle.

In this example, the total compensation cost at the conclusion of the performance cycle under APB 25 is equal to \$160,000 (10,000 options multiplied by \$16, which is the increase in share price over the exercise price).

Results Under FAS 123

Using the same facts, assuming the fair value of the option is \$17.15, the total expense at the date of grant under FAS 123 would be equal to \$171,500 (10,000 options multiplied by \$17.15).

Under FAS 123, the opportunity for a benefit occurs if the stock price exceeds the projection yielded under the valuation model. If the stock price had continued to increase to \$100 per share, the APB 25 expense would have increased to \$500,000 (10,000 options multiplied by \$50), and the FAS 123 expense would have remained at the grant date value of \$171,500.

EXAMPLE OF A TRADITIONAL, FIXED ACCOUNTING STOCK OPTION PLAN

Figure 2

Facts

- 10,000 options granted on Jan. 1, 2000, at an exercise price of \$50
- The stock price on Jan. 1, 2000, is \$50 per share

Result Under APB 25

The compensation cost will be zero because the exercise price equals the stock price at date of grant. Therefore, there is no intrinsic value at the measurement date.

Result Under FAS 123

Additionally, for the option-valuation model, assume the following variables:

- Risk-free rate is 7.5 percent.
- Expected life of the option is six years.
- Expected volatility is 30 percent.
- Expected dividend yield is 2.5 percent.

The Black-Scholes Model would yield a fair value of \$17.15 per share. Under FAS 123, measuring the fair value of the options at the date of grant would yield the following option value and compensation expense: 10,000 options x \$17.15 value = \$171,500.

Typically, this amount would be expensed over the vesting period of the grant and would be adjusted to reflect forfeitures. A review of the \$171,500 expense under FAS 123 vs. zero compensation expense under APB 25 clearly indicates why the majority of companies granting traditional stock options do not elect to adopt FAS 123. However, there is a potential expense planning opportunity under FAS 123. Companies that use performance-based stock plans can actually benefit from adopting FAS 123.