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Client Alert

A report for clients and friends of the firm

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FASB Annual Disclosure Requirements for Share-Based Payments

On December 15, 2004, the Financial Accounting Standards Board ("FASB") adopted Statement of Financial Accounting Standards No. 123(R) ("SFAS No. 123(R)"). This generally accepted accounting principle is controversial, particularly as it applies to accounting for stock options. It requires that equity compensation for both public and private companies be accounted for in the company's financial statements at fair value. The accounting controversy and the complexity of the 297-page standard, which is accompanied by the FASB's responses to 24 frequently asked questions about the standard, may result in the standard's extensive footnote disclosure provisions being overlooked.

Assuming that it is not delayed or derailed by Congressional or judicial action, SFAS No. 123(R) will be effective for financial statements of companies, other than those which qualify as "small business issuers" and non-public companies, as of the beginning of the first interim or annual reporting period that begins after June 15, 2005, subject to complex transition requirements. For small business issuers, the effective date will be the beginning of the first interim or annual reporting period that begins after December 15, 2005, and for non-public companies, the beginning of the first annual reporting period that begins after December 15, 2005.

The footnote disclosure required by paragraphs 64 and 65 of SFAS No. 123(R) will be effective for the first annual financial statements prepared under the new standard. This disclosure will not be required in footnotes to interim financial statements in quarterly reports. Paragraphs A 240-242 (Minimum Disclosure Requirements and Illustrative Disclosures) of Appendix A to the SFAS No. 123(R), which is an integral part of the standard, elaborate on these disclosure requirements. These paragraphs cover eight pages, including four pages of illustrative disclosure for two hypothetical stock option plans.

An explanation of the accounting requirements of SFAS No. 123(R) is best left to knowledgeable accountants and valuation experts. However, this Client Alert addresses the new disclosure requirements because they well may inform Securities Exchange Commission rulemaking and enforcement actions with respect to executive compensation disclosure and activist stockholders' actions with respect to compensation matters and should be considered by compensation committees in reviewing and determining executive compensation and preparing their reports required under SEC rules.

These new requirements, which require disclosure in addition to that required by SEC rules and by the New York Stock Exchange for its listed companies, also add additional elements to the disclosure controls and procedures required by SEC rules, may require additional staffing to implement and will be covered by the required certifications by CEOs and CFOs. Moreover, even absent SEC rulemaking, companies may have to consider whether the disclosure in their proxy statements or MD&As, in some respects, should be at least as extensive as that required by SFAS No. 123(R) in the footnotes to their financial statements. This may be especially relevant when a company, under stock exchange or Nasdaq requirements, is seeking stockholder approval of an equity compensation plan.

The Required Disclosure

The FASB has indicated that, in some circumstances, a company "may need to disclose information beyond that listed in [Paragraph A 240] to achieve the disclosure objectives [of SFAS No. 123(R)]." Information for awards under multiple payment arrangements may be required to be disclosed separately for different types of awards "to the extent that the differences in the characteristics of the awards make separate disclosure important to an understanding of the [company's] share-based compensation." The FASB also indicated that a company may disclose additional information it believes would be useful for investors and creditors "provided that the supplemental information is reasonable and does not lessen the prominence and credibility of the information required by [SFAS No. 123(R)]."

This could result in compensation disclosure not only being subject to SEC, NYSE and stockholder scrutiny but also being scrutinized by a company's outside auditors and the inspection staff of the Public Company Accounting Oversight Board, which has indicated that it will review the application of GAAP standards as part of its inspections.

The disclosure required by Paragraphs 64, 65 and A 240 for public companies includes:

- A description of any share-based plan, including such matters as the required service period, vesting conditions, maximum option terms, number of shares authorized for awards and the method used to determine compensation cost;

- For the most recent year for which an income statement is provided:

  - The number and weighted-average exercise prices of share options or units outstanding at the beginning and end of the year, those exercisable at the end of the year and those granted, exercised, forfeited or which expired during the year; and

  - The number and weighted-average grant date fair value for equity instruments other than options that are not vested at the beginning and end of the year and those that were granted, vested or forfeited during the year;

- For each year for which an income statement is provided:

  - The weighted average grant date fair value of options or other equity instruments granted during the year; and

  - The total intrinsic value of options exercised, share-based liabilities paid and the total fair value of shares vested during the year;

- For fully vested share options or units and options or units expected to vest at the date of the latest statement of financial position:

  - The number, weighted-average exercise price, aggregate intrinsic value and weighted-average remaining contractual term of options that are outstanding; and

  - The number, weighted-average exercise price, aggregate intrinsic value and weighted average remaining contractual term of options that are currently exercisable;

- For each year for which an income statement is presented:

  - A description of the method used to arrive at fair values; and

  - A description of the significant assumptions used to estimate fair values, including expected terms of options, expected volatility of the company's shares, expected dividends and risk-free interest rates used.

- For each year for which an income statement is presented:

  - Total compensation cost for share-based payment arrangements recognized in income, the total recognized related tax benefit and the total compensation cost capitalized; and

  - A description of the terms of significant modifications of share-based arrangements, including the total number of employees affected and the total related incremental compensation cost.

- As of the latest balance sheet date, the total compensation cost related to non-vested awards not yet recognized and the weighted average period over which it is expected to be recognized;

- If not disclosed elsewhere, the amount of cash received from exercise of options and the cash benefit of related tax benefits during the annual period and the amount of cash used to settle share-based payment arrangements; and

- A description of the company's policy, if any, for issuing shares upon the exercise of options, including the source of shares (newly issued or treasury) and an estimate of the amount (or range of amounts) of shares, if any, that the company expects to repurchase during the next annual period to fund exercises.

Conclusion

These new disclosure requirements, coupled with existing and prospective SEC requirements for disclosure of executive compensation, the uncertain treatment of certain types of "deferred compensation" under the American Jobs Creation Act and prospective new independence rules for auditors providing tax services, could place additional strains on reporting companies' already over- burdened disclosure compliance processes and their audit and compensation committees.

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Proskauer's Capital Markets Group has extensive experience in all types of capital markets transactions, including both registered and exempt transactions. We represent domestic and foreign private issuers and underwriters in registered transactions and exempt Rule 144A, Regulation S and Regulation D transactions. We provide the full range of services required by our domestic and international clients to facilitate initial public offerings, follow-on offerings, investment-grade, convertible and high-yield debt offerings and real estate securities transactions.

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