by Rob Renaud (Contact Author | Biography)

If you are a particularly diligent investor or a serious financial newshound, you may have heard of FAS 123R. For those of you who don't know about it, FAS 123R is the new financial accounting standard introduced by the Financial Accounting Standards Board (FASB) that requires companies to deduct the amount of share-based (equity) payment granted to their employees on an annual basis. Here we look at why this accounting standard has come about, what it involves and how it may affect you.

Why Introduce This Rule?

Many employees receive equity compensation as a supplement to their salaries. Traditionally, this compensation comes in the form of stock option grants, which can be exchanged for shares of the company's stock. The basic idea behind FAS 123R is that the costs associated with equity payment for employee services are to be expensed on financial statements in order to reflect the economic transaction taking place between a company and its employees. (For further reading, see *Show And Tell: The Importance Of Transparency*.)

Equity compensation was not expensed previously because it is not a real monetary expense to a company. However, equity compensation *is* a direct expense to a company's shareholders. Shareholders are the owners of publicly-traded companies and, therefore, they are the ones who ultimately pay for the issue of extra shares through dilution. When additional shares are issued by a company or convertible securities are converted, dilution occurs. If there were 10 shares in a given company, issuing five more shares for equity compensation would mean that the previous owners of the 10 shares would see their stake in the company reduced to only two-thirds. (To learn more, see *The "True" Cost Of Stock Options*.)

How It Affects You

Why should this matter to you as an investor? Well, if you have a lot of money tied up in stocks, FAS 123R has the potential to take a substantial bite out of your portfolio's value. In the past, a company that issued stock options to its employees did not have to expense those options; for example, a grant of 500,000 options to an executive would cost the company nothing on paper. Now, the FASB requires companies to charge the option grant multiplied by the fair value of the grant. Continuing with our example, let's assume that the grant is $10 per option, for a total of $5 million (500,000 options x $10 per option) in equity compensation expense. To be in compliance with FAS 123R, the company now would have to expense this $5 million, thus affecting its financial performance.

As you can see, this new way of doing things could greatly affect the profitability of some companies. If you have many companies in your portfolio that rely on options to keep their executives happy, you should be aware that the stocks of these companies may be on their way to a price correction based on the news that their earnings have decreased substantially as a result of options expensing.

Arguments for and Against

Opponents of employee stock option (ESO) expensing say that option grants help companies attract and motivate key employees and that they align shareholder interests (i.e. an increase in share price) with the interests of grantees (i.e. an increase in option value). They also argue that if companies are required to expense options, they will likely use other forms of compensation instead

- ones that do not align the goals of shareholders with those of grantees.

On the other hand, those who support ESO expensing argue that equity compensation transfers stockholders' equity to grantees - they get $5 million that otherwise would have been left with the company. These proponents of the new rules maintain that if salary is expensed as an exchange for employee services, then it follows that equity-based compensation for the same employee services should also be expensed.

What Will Change?
Even though FAS 123R puts stock-based compensation expenses on companies' balance sheets, the people who receive the most stock options will likely keep seeing the same levels of compensation they have always seen.

According to a survey of 350 companies conducted by Deloitte & Touche, upper-echelon executives receive the vast majority of equity-based compensation (Deloitte & Touche, 2005). The question now is this: how will equity-compensated executives continue to earn millions of dollars without making their balance sheets glow with red ink? Executive compensation experts and securities lawyers are frantically seeking ways to resolve this conundrum.

In the face of FAS 123R, equity compensation has changed - options are no longer the preferred means of rewarding executives, and new ways to reward good corporate performance have emerged. Some of these, such as reload options, have been dug up from the 1990s - the heyday of bull market fever and ESO granting. From the point of view of the investor, these new vehicles for compensation are not only intimidating and complicated, but hard to value, especially considering that the FASB has yet to come out with explicit guidelines for 2006, and continues to indicate that it may alter 123R further.

The future of equity compensation is probably a derivative that has not yet been engineered. Before FAS 123R, options did not explicitly take away from a company's balance sheet earnings; so, despite their flaws, they were inherently more attractive than other compensation vehicles. Now, granting common stock, stock appreciation rights (SARs), dividends, options, or other derivatives of stock-based incentives are all equally expensive approaches to employee compensation, making the best incentives the ones that have the most motivational power.

From the investor's standpoint, equity compensation should not unduly dilute shareholders' ownership, should pay executives for market capitalization appreciation instead of stock price appreciation (which can be easily manipulated by using share buybacks), and should be simple enough to dissect without having to spend days plowing through the legalese of a mandatory filing. From the executive's standpoint, equity compensation should be highly levered to provide exponentially high compensation for exceptional performance, and it should not expose them to potentially punitive income taxes.

Conclusion
Whatever the future brings, expect some market correction of share prices as a result of the new FAS 123R option expensing regulations before a magic new derivative takes the place of good old stock options. Because FAS 123R is a change in financial reporting requirements, its implementation will change the bottom line profitability of many companies. If you have a portfolio of stocks, you would be well advised to look ahead to see if this new reporting requirement will

have a material effect on the reported financial performance of the companies in your portfolio.

For further reading, see *Option Compensation - Part One* and *Option Compensation - Part Two*.

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