

Insight Through the Power of Research

Client Memorandum

May 2005



Employee Stock Options

With FAS 123(R) implementation looming, we believe it is important to understand how the investment community is currently viewing the subject of expensing employee stock options as it pertains to financial results and stock valuation. With this insight, our clients should be in a better position to communicate the impact of this new expense in their financial reports, and at the same time reduce the possibility of confusion in the market.

Fortunately, most companies will now have more time to plan their implementation and communications strategies. In mid-April, the Securities and Exchange Commission (SEC) postponed the effective date of the Financial Accounting Standards Board's pending rule, FAS 123(R). The rule change only defers implementation, not the eventual impact of the rule. FAS 123(R) is now effective for annual periods that begin after June 15, 2005. For public companies with a calendar year end, this means that they must begin expensing employee stock options upon reporting their first quarter ending March 31, 2006. For issuers with non-calendar fiscal year-ends, the effect of the deferral depends on when their new fiscal years begin.

While the SEC's decision to delay the effective date may be a welcome reprieve, we believe issuers can benefit from immediate efforts to resolve certain areas of confusion before compliance is mandatory. One area of such confusion has already manifested itself in First Call's process of developing mean EPS estimates. There is no agreement between analysts on whether or not they should include the expense in calcula-

tions of EPS for their First Call estimates. Not only is there the issue of comparability of analysts' estimates between those that include the expense versus those that do not, there is the potential for unduly negative comparisons when a company reports GAAP EPS, and the First Call mean estimate excludes the expense. We can envision media headlines that cite an earnings miss when, in reality, the First Call estimate overstates actual earnings.

For almost a decade, some leaders of federal regulatory agencies and the accounting profession insisted that the failure to account for employee stock options had weakened the credibility of corporate financial reporting. Just as vocal, the influential lobby representing the high-tech industry urged Congress to block the expensing of stock options. A coalition of high-tech firms has long asserted that the best way for fast-growing companies to attract talent is to award stock options to employees and executives. In addition, pressure from members of Congress (many of whom represented regions with heavy concentrations of high-tech firms) urged the SEC to back away from its drive for expensing in 1997. Public and political pressure, however, for broad-scale reforms in accounting and corporate governance was revived after the bursting of the stock-market bubble, the revelation of widespread corporate abuses, and the passage of the Sarbanes-Oxley corporate reform law. The new FAS rule is an outgrowth of that longer-range reform effort, seeking to ensure the transparency and full disclosure of corporations' finances.

Recently, we surveyed the professional investment community for its views on the subject. What surfaced was a picture of contradictions that we anticipate will complicate the task of communicating financial results. The survey also found that the topic is still not a top-of-mind issue for many investors. Investors who have portfolios with above-average exposure to technology stocks (referred to as "technology-oriented investors" in this report), as a subset of those surveyed, may even be discounting the importance of expensing employee stock options.

Key findings of our survey:

1. Investors across the board are in favor of expensing employee stock options. The expected benefits cited are greater transparency and comparability of financial statements.
2. Despite this support, the expense is expected to have negative implications for equity valuations in the near term. Paradoxically, virtually no one thought the benefits would translate into improved valuations for stocks.
3. Half of the respondents plan to adjust reported GAAP earnings to arrive at pro-forma earnings.
4. 30% believe that price/earnings ratios will be less relevant for equity valuation. For companies that will feel a material impact from FAS 123(R), particularly technology companies, investors anticipate that the adoption of alternative equity valuation methodologies will increase in importance and use. Of the methods we queried, two stood out as the most viable alternatives – discounted cash flow models and enterprise value-to-EBITDA (EV/EBITDA).
5. Investors generally view favorably companies who choose to implement FAS 123(R) before they are required to do so.

Employee Stock Options Survey Details

Investors are strongly in favor of expensing options

Overall nearly 80 percent of investors believe that expensing employee stock options is important to some degree. This finding is consistent with the level of attention this topic has been given in the news media. The key benefits of expensing employee stock options cited by respondents are greater transparency and comparability of financial statements. Not surprisingly, since results of technology companies will generally realize a larger impact from the expense, technology-oriented investors were much less adamant about the importance of expensing options. Slightly more than one-third of these investors and analysts thought that it was important or very important to expense options, compared to almost 56% of non-technology-oriented investors.

Negative impact on equity valuations anticipated

A majority (approximately two-thirds) of respondents thought that the expensing of options would have a near-term (less than one year) negative impact on valuations. Concerns about valuations over the longer term abate somewhat, but are still material. Beyond one year, more than 40% of respondents indicated that they believed there will be a negative impact. Despite the favorable philosophical stance of investors toward expensing options, very few thought that the greater level of disclosure would be positive for stock valuations. Slightly more than 12% thought there would be a near-term lift; this increases to only 17% longer term.

Uncertainty in GAAP versus pro-forma earnings

There was a dramatic split on the question of how to view the reported EPS figure after FAS 123(R) has gone into effect. Overall, half of investors will use GAAP EPS; the other half will make adjustments to arrive at a pro-forma number. Again, there is a dramatic divergence in the way technology-oriented investors and analysts will use reported earnings. Two-thirds of the non-technology-oriented investors will use standard GAAP earnings as the basis for analyzing and valuing stocks. Because technology companies, in general, will be more affected by the expense, more than 60% of technology-oriented investors will be making adjustments to reported earnings to arrive at what they think will be more relevant figures for analysis and valuation.

Broader use of additional valuation methodologies anticipated

Based on the results regarding the treatment of EPS, one might ask: As a result of these changing perceptions of the traditional unit of earnings (EPS) by investors, will valuation methodologies have to change to accommodate that? In other words, will the relevance of the price/earnings ratio decline as investors seek to determine the appropriate price of a share of stock? Throughout our analysis, the survey respondents tell us that the answer depends on the market sector in which they focus their investments. Overall, 70% indicated that the price/earnings ratio would not be co-opted as the primary valuation tool. 90% of non-technology-oriented investors held that price/earnings ratio would retain its importance. In contrast, over 43%, or almost half, of technology-oriented investors thought that price/earnings ratio would decline in relevance as a valuation measure, and would be augmented by discounted cash flow and EV/EBITDA valuation models.

Early adoption of FAS 123(R) seen as positive

A majority of investors indicated that it would view positively corporations that voluntarily adopted tighter accounting rules before FAS 123(R) goes into effect. Overall, 61% said they would be favorably impressed by a company that implemented FAS 123(R) early; even in the technology sector, 56% agreed. Investor regard, and thus investor confidence, would be strengthened by early, voluntary compliance with standards perceived to improve transparency.

Preferred methodology for calculating the expense is clear

Excluding the investors who were indifferent to the method of determining fair value, the Black-Scholes model was the consistent choice of the balance of investors.

Pending issues with First Call estimates

We are hearing that analysts are unsure how to treat FAS 123(R) expense in their estimates that they are providing to First Call. In our conversations with First Call we have been advised that First Call will not impose any requirement on analysts in their treatment of the FAS 123(R) expense. Whatever methodology is

used by the majority of covering analysts will be the standard for calculating the First Call estimate. Other estimates will be excluded from the mean and put into an alternate table.

The problem that this creates is twofold.

First, comparability between companies will be difficult if the analysts covering one company are conforming to GAAP figures and analysts covering another are making adjustments to arrive at pro forma estimates.

Second, the financial media take the reported GAAP EPS figure and compare it to the First Call estimate to determine performance versus expectations. We can foresee situations where the First Call estimate will exclude a substantial expense under FAS 123(R) and there will be confusion as to whether a company has or has not met the First Call number.

Reporting of share-based payment expense

In the Staff Accounting Bulletin #107, the SEC said that any net income figure that removes the effects of accounting for share-based payment arrangements meets the definition of a non-GAAP, or pro forma measure. Accordingly, any measure, that excludes share-based payment must satisfy Regulation G requirements.

We recommend addressing the issue of implementing FAS 123(R) promptly to allow time for proper analysis and strategizing.



Employee Stock Options

Recommendations for Issuers

1. Consider adopting FAS 123(R) as early as possible. There was a strong preference in the survey for reporting of option expense in advance of the requirement. Insofar as the expense must be reflected within a few quarters anyway, we believe companies can gain credibility for transparency while not postponing the inevitable.
3. Include the expense in analysts' First Call estimates. Work with the company's covering analysts to encourage them to factor in the expense in their models and estimates. This will enable reported GAAP earnings to most closely correlate to First Call estimates, and reduce potential confusion.

Even if the determination is made not to adopt early reporting, there are complex decisions to make regarding the accounting for and communication of the expense, and we advise addressing the issue promptly to allow sufficient time for proper analysis and strategizing.

2. Break out the amount of the expense in the text of your earnings release, and consider adding a supplemental table showing the impact of the expense on earnings. Since it will be a potentially large expense that was not included in prior financial statements, and analysts/investors may not be including it in their financial models, we advise highlighting the figure in current and prior periods. This will enable investors to make any necessary calculations to arrive at whatever comparable version of net income they believe most relevant.
4. Consider new metrics to communicate. If a company anticipates that its EPS figure will change materially as a result of FAS 123(R), then it should be prepared to address new metrics which investors should be encouraged to monitor. Our survey identified that discounting techniques and EV/EBITDA models will increase in importance. We believe this would be a good place to start when determining what new metrics to begin highlighting.
5. Consider how to address comparability across periods. There are two options to address comparability to previous periods. One is to generate pro-forma EPS or provide enough detailed information to allow investors to make their own adjustments. The other option is to restate financial results from past periods. IBM, for example, began expensing stock-based compensation in the Company's first quarter, ended March 31, 2005. The Company restated prior financial results to include the impact of stock-based compensation expenses.



If you have any questions or comments, please contact:

Gordon McCoun
+1 212 850 5681

Jason Golz
+1 415 439 4532

U.S. Headquarters

Wall Street Plaza
88 Pine Street, 32nd Floor
New York, NY 10005 USA

Tel: +1 212 850 5600

European Headquarters

Holborn Gate
26 Southampton Buildings
London WC2A 1PB

Tel: +44 207 831 3113