

# COMPLIANCE WEEK

## Companies Re-evaluating Employee Stock Purchase Plans

By Karen M. Kroll — June 14, 2005

Much of the attention paid to FAS 123R, the Financial Accounting Standards Board's hotly debated stock option expensing rule, has focused on the regulation's impact on employee stock option plans. Less noticed has been 123R's impact on employee stock purchase plans.

In fact, the rule—officially called "Share-Based Payment"—significantly alters the accounting of ESPPs by determining that most employee share purchase plans are "compensatory"; that is, they give rise to a recognizable compensation cost. The only plans that do not require expensing are ones that basically are "no more favorable" than those available to all shareholders of the same class of shares.

Rebecca Miller, a managing director at accounting firm RSM McGladrey, says that ESPPs typically are compensatory when any of the following criteria are met:

1. The discount from the share price offered to employees exceeds 5 percent;
2. The plan allows for a lookback period, so employees can retroactively choose whether to purchase share(s) at the beginning or end of a purchase period; or
3. The plan is not available to substantially all employees who meet limited employment qualifications.

Since most ESPPs are considered compensatory, FAS 123R is causing many companies to evaluate and change their employee stock purchase plans. "From what I've heard, every company in the world is re-examining its ESPP," says Bruce Brumberg, editor-in-chief of myStockOptions.com, an online provider of stock plan education based in Brookline, Mass.

### A Dynamic Math Problem



Miller

she says.

FAS 123R requires companies to expense the value of the shares purchased through the ESPPs. As might be expected, the calculations can get involved. Miller points to the 2003 Annual Report of Intel Corp., in which the company outlines the criteria used to estimate the weighted average value of the rights granted under its Stock Participation Plan. These include the expected life, or purchase period; the company's risk-free interest rate; the stock's volatility and its dividend yield. "It's a multi-dimensional, dynamic math problem,"

Given the time and cost required to include the impact of ESPPs on the income statement, recent surveys show that a fair number of companies offering these plans are making changes to or even eliminating them.

Case in point: About one-fourth of the 53 high-tech companies that participated in a March 2005 survey by compensation experts Culpepper and Associates said they are planning some sort of changes to their equity compensation plans. 11 percent

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of respondents are eliminating the “lookback” feature, while 8 percent are reducing the discount given to employees when they purchase stock. Another 5 percent are making some other change.

Over half had not yet decided on the changes they would make, and 8 percent are eliminating the plan entirely. “There is a pretty heavy re-evaluation of the equity compensation plans going on in tech companies,” says Will Parsons, senior vice president of research with Culpepper.

The numbers coming from a study reported in the April 2005 newsletter of compensation research firm Equilar appeared a bit more optimistic. Equilar examined 45 newly established or recently amended ESPPs. Among this group, 91 percent offered a 15 percent discount on shares purchased through the ESPP, and 39 percent contained a six-month lookback.

Equilar president Tim Ranzetta cautions that the sample size was small, and would not have included companies that decided to discontinue or not to implement an ESPP. However, it did provide some insight into how ESPPs are being modified. Specifically, Ranzetta theorizes that companies in the survey may be using their ESPPs to replace—at least in part—any reductions they’re making to their stock option plans. “This increases the importance of ESPPs to fill in the gaps,” he notes. “Companies are leery of cutting broad-based options plans and also eliminating their ESPPs.”

In another survey by the National Center for Employee Ownership, 66 percent of the 85 companies that offered a qualified ESPP stated they were not planning to discontinue their plan because of the new rules; 28 percent were still deciding. About 46 percent were still deciding whether to modify their plan in light of ESPP, while 24 percent were going to modify their plans.

Individual companies reflect the trends seen in the surveys. According to its 2004 Form 10-K, Microsoft disclosed it had approved a reduction in its ESPP share price discount from 15 to 10 percent, as well as the elimination of the lookback period, and a reduction in the purchase period from six to three months.

Similarly, \$529.2 million Industrial Distribution Corporation disclosed it is changing its ESPP as of July 1. Previously, employees with the Atlanta-based firm could purchase the company’s stock at a 15 percent discount off the lower of the price on the first or last trading day of the month. The new plan will have a 5 percent discount and no lookback period, says Jack Healey, senior vice president and chief financial officer.


Healey identifies several reasons for the change. This year, the charge resulting from the switch would have amounted to 2 cents per share—a line item that would only increase as the stock price presumably went up. In addition, Healey estimated that completing the calculations to comply with FAS 123R would have taken two hours each month of a staff person’s time. Finally, just one-sixth of the company’s 1,400 employees benefit use the plan; IDG encourages its employees to first invest in their 401(k) retirement accounts.


International Rectifier, a \$1.0 billion manufacturer of power semiconductors based in El Segundo, Calif., has decided to put its employee stock purchase plan on hold with the period ending June 30, 2005, says EVP and CFO Mike McGee. “The new rules would require a meaningful expense,” he notes. He adds that the company is examining its entire compensation package in order to determine how best to remain competitive, while maintaining a lid on costs.

The changes imposed by FAS 123R may prompt companies to look more closely at other forms of equity compensation that traditionally have had a small following, says Parsons of Culpepper and Associates. For example, about 26 percent of high-tech companies currently offer restricted stock to their employees. That number could jump to around 50 percent in light of FAS 123R, he estimates.

Restricted shares are transferred from the company to employees, typically at the senior management level, with some restrictions. For instance, the employee may be granted 100 restricted shares, but obtain full ownership at a rate of 25 shares each year for four years. Or, the company may have to hit certain revenue targets in order for the employee to take ownership of the shares.

The accounting for restricted shares is fairly straightforward, says Miller at RSM McGladrey. The stock is valued at the grant date, and then the expense reported ratably over the vesting period.

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At least a few compensation analysts say the changes wrought by FAS 123R on ESPPs should have received more attention, as they impact a wider range of employees than do changes to employee stock option plans, notes Brumberg. "More employees are eligible for ESPPs than stock options," he notes. "A true middle class benefit is shifting in ways to make it less beneficial."

Related coverage and commentary, as well as the actual FASB statement and a list of frequently asked questions, is available from the box above, right.

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