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FASB Announces Planned Effective Date and
Method of Transition for Stock Option Expensing Mandate
And Reaches Further Convergence With IASB

The Financial Accounting Standards Board (FASB) met six times from mid-September to the end of October to further deliberate key issues on its stock option expensing project, now referred to as "equity-based compensation" (EBC). This letter is intended to update our readers on the most substantive developments occurring during these meetings.

> Most important, the FASB on October 29, 2003 tentatively decided that, for public companies, the proposed standard would be effective for fiscal years *beginning* after December 15, 2004, i.e., 2005 financial statements for calendar year companies. Earlier adoption in 2004 would be encouraged, assuming the final standard is released in the third quarter of 2004 as planned.
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> Companies would be required to adopt the new standard using a "modified prospective" method, meaning that EBC cost would be recognized for all employee awards granted, modified, or settled after the effective date, plus the nonvested portion of awards granted or modified in fiscal years beginning after December 15, 1994. Nonvested awards at the effective date would be "valued" in accordance with the original provisions of FASB Statement No. 123 (FAS 123), as opposed to any differing provisions under the final new standard. The FASB plans to solicit feedback when it releases an Exposure Draft (ED) in the first quarter of 2004 as to whether a "modified retrospective application" method should also be allowed, permitting companies to "restate" prior reporting periods in a manner consistent with historic FAS 123 pro forma net income and earnings per share footnote disclosures.
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> The proposed FASB approach is conceptually similar to the International Accounting Standards Board's (IASB) proposal on "Share-based Payment," which is now scheduled to become effective for fiscal years beginning on or after January 1, 2005 on a modified prospective basis for all awards granted after the November 7, 2002 release of the IASB ED, with full retroactive application permitted for companies previously disclosing FAS 123 costs in financial statement footnotes.

Other substantive decisions tentatively reached by the FASB over the last month and a half include the following:

Convergence With IASB – The FASB and IASB continue to work closely to ensure convergence with each organization's final standard. At a joint FASB/IASB meeting on October 22, 2003, the IASB agreed to accept the FASB's position in regard to income tax effects and "reload" stock options. Under the final standard for both organizations, differences between aggregate EBC deductions recognized in financial statements and realized on tax returns would be credited/debited to paid-in-capital on the balance sheet, and would not flow through the income statement as the IASB originally proposed. In addition, stock options with a reload feature would be valued separately for each subsequent reload grant, as opposed to only once on the award's original grant date as the IASB originally proposed. Once the FASB completes all phases of its EBC project (including transactions with nonemployees) and the FASB and IASB have completed their projects related to the classification of liabilities and equity, the FASB and IASB plan to undertake a final convergence project with the objective of eliminating all remaining differences with respect to EBC.

Reversal of Compensation Cost – An important concept under the proposed "modified grant date" approach is that compensation cost for employee EBC is not recognized for awards that are forfeited because of an employee's failure to fulfill a "service" or "performance" condition. The FASB has subtly redefined these definitions such that a service condition is based solely on an employee's rendering services to the company for a specified period of time, and a performance condition is based on achieving a specified performance target that is referenced solely to the company's own operations or activities. Importantly, EBC cost is not reversed if an award's exercise price or exercisability is tied solely to a stock price or intrinsic value "market condition" (or similar equity security or index), or a vested stock option expires unexercised. If the exercise price or exercisability of an EBC award is affected by something other than a service, performance, or market condition (or if the terms of an EBC award "cease to be mutually understood"), the award should be accounted for as an EBC liability, requiring variable "fair value" accruals for the entire existence of the award.

Award Modifications and Cash Settlements – Under FAS 123, award modifications are accounted for as an exchange of the original award for a new "modified" award. Incremental compensation cost is measured by the difference between (1) the fair value of the new award using standard FAS 123 valuation methodology, and (2) the fair value of the original award using FAS 123 assumptions as of the modification date and, for stock options, the shorter of the expected remaining life of the original award or the expected life of the new award (to preclude the counterintuitive possibility of a reduction in compensation cost as a result of the modification). "Intrinsic value" is substituted for fair value in the second part of the calculation above in instances where the original award has no remaining expected life or was granted before the effective date of FAS 123 (1995 for calendar year companies). Cash settlements of outstanding equity awards are accounted for in the same manner as award modifications except that "the amount of cash paid" is substituted for the fair value of the new award in the first part of the calculation above.

Any incremental compensation cost calculated above is recognized either (1) immediately if the original award is vested as of the modification date, or (2) over the remaining vesting (service) period if the award is nonvested as of the modification date. There is never "decremental" compensation cost recognized in connection with an EBC award modification.

Award modifications under FASB's proposed final standard are generally consistent with the provisions of FAS 123, except that the "shorter of" provision would be eliminated and replaced with a requirement that a company may never recognize less than the grant date fair value of an EBC award, unless the employee fails to vest under the terms of the original award.

A brief summary of the significant differences between FAS 123 and the IASB proposal (ED 2) and the FASB's tentative conclusions to date is presented at the end of this letter.

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General questions about this letter can be addressed to Thomas M. Haines or Cimi B. Silverberg in our Chicago office at 312-332-0190 or by email at tmhaines@fwcook.com or cbsilverberg@fwcook.com. Copies of this letter and other related letters on this topic are available on our website at www.fwcook.com under the following links:

- September 18, 2003 – FASB Delays Timetable on Stock Compensation Project But Project Derailment Still Not Likely-- http://www.fwcook.com/alert_letters/9-18-03-FASB%20De&ion%20Project.pdf

- August 8, 2003 – Valuation of Employee Stock Options: Summary of Views from FASB's Option Valuation Group -- http://www.fwcook.com/alert_letters/8-8-03ValuationEmployee.pdf

- June 23, 2003 – FASB Makes Headway on Stock Compensation Project -- http://www.fwcook.com/alert_letters/6-24-03-FASB%20Makes%20Headway%20on%20Stock%20Compensation%20Project.pdf

- March 14, 2003 – FASB Decides to Add Stock Compensation Project to Agenda -- http://www.fwcook.com/alert_letters/3-14-03-FASB%20to%20Add%20Stock%20Comp%20Project%20to%20Agenda.pdf

- January 10, 2003 – FASB Issues Final Standard on Amendments to Statement 123 -- http://www.fwcook.com/alert_letters/1-10-03-FASBIssuesFinalStandard.pdf

- December 23, 2002 – FASB Releases Invitation to Comment on IASB Share-Based Payment Exposure Draft -- http://www.fwcook.com/alert_letters/12-02FASBReleaseInvitationTo%5B1%5D....pdf

- October 11, 2002 – FASB Releases Exposure Draft on Amendments to Statement 123 -- http://www.fwcook.com/alert_letters/10-11-02FASBReleasesExposure....pdf

- March 20, 1996 – Compliance With The Footnote Disclosure Requirements of FAS 123 -- http://www.fwcook.com/032096.html

- November 8, 1995 – FASB Releases Final Standard on Accounting for Stock-Based Compensation -- http://www.fwcook.com/alert_letters/11895TMH.pdf

Differences Between FAS 123 and IASB ED 2 and <u>Tentative FASB Conclusions to Date</u>

Issue	IASB ED 2 Methodology	FAS 123 Methodology	FASB Tentative Conclusions to Date
Measurement Focus	Goods or services received	Equity instruments issued	FAS 123 approach *(May 7, 2003)*
Measurement Approach	Grant date	Modified grant date	FAS 123 approach *(May 7, 2003 reaffirmed June 18, 2003)*
Treatment of Forfeitures	Reduce grant date fair value (both service and performance conditions)	No reduction to fair value for estimated forfeitures	Apparently will retain FAS 123 approach based on decisions for "measurement approach" and "reversal of forfeitures" identified above and below, respectively *(May 7, 2003 reaffirmed June 18, 2003)*
Reversal of Forfeitures	No, previously accrued cost never reversed (but no additional cost recognized)	Yes, if not related to a stock price or intrinsic value condition (or expiration of an unexercised stock option)	FAS 123 approach *(May 7, 2003 reaffirmed June 18, 2003, October 8, 2003, and October 29, 2003)*
Accrual of Cost	Units-of-service method (based solely on service conditions, not performance conditions)	Ratably or on accelerated basis over vesting period based on expected outcome	FAS 123 approach *(May 7, 2003 reaffirmed June 18, 2003 and October 1, 2003)*
Treatment of Income Taxes	All tax effects flow through income statement	Excess tax benefits credited to equity on balance sheet	FAS 123 approach *(July 23, 2003 reaffirmed October 15, 2003 and October 22, 2003)*
Exclusions from Scope	No exceptions, unless within the scope of another standard, e.g., business combinations	Exceptions for ESOPs and ESPPs with minimal purchase discounts and no option features	IASB approach for ESPPs *(September 10, 2003)* ESOPs deferred until "second phase" of project *(September 10, 2003)*
Transactions with Nonemployees	Treated the same as employees	Modified vesting date approach under EITF 96-18	Exploring "exchange date" approach; trying to treat employee and nonemployee transactions consistently *(June 18, 2003)* Transactions with nonemployees deferred until "second phase" of project *(September 10, 2003)*
Nonpublic Companies	Treated the same as public companies	Can use "minimum value" methodology (no volatility estimate)	IASB approach *(September 10, 2003)*
Black-Scholes Inputs	"Average-of-range" estimates	"Low-end or high-end of range" estimates	IASB approach *(October 15, 2003)*
Stock-based Awards Settled in Cash	Compensation cost based on fair value	Compensation cost based on intrinsic value	IASB approach *(August 13, 2003)*
Reload Stock Options	Valued as part of original grant, if possible	Each reload grant valued separately	FAS 123 approach *(September 10, 2003 reaffirmed October 22, 2003)*