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<u>IASB Issues Final Standard on Share-based Payment</u>

Global Option Expensing Another Step Closer to Reality

The International Accounting Standards Board (IASB) on February 19, 2004 issued its much anticipated International Financial Reporting Standard (IFRS) on accounting for equity-based compensation (EBC), referred to as "IFRS 2 Share-based Payment." Simultaneously, the U.K. Accounting Standards Board announced its intention to issue an accounting standard referred to as "FRS 20" that would require expensing of share option schemes and other share-based payments beginning on or after January 1, 2005 for listed companies (January 1, 2006 for all other companies). In addition, late last year the Canadian Accounting Standards Board (AcSB) completed its project on share-based payment that requires option expensing for financial periods beginning on or after January 1, 2004 for public companies (January 1, 2005 for most private companies).

> The IASB's final standard becomes effective on a "modified retroactive" basis beginning on January 1, 2005, and with few exceptions, will apply broadly to all types of EBC transactions with employees and nonemployees. In the spirit of international convergence, the IASB has worked closely with the Financial Accounting Standards Board (FASB) to substantively conform its final standard to the "modified grant date fair value" principles tentatively embodied in the FASB's EBC project. The FASB, meanwhile, is on track to release an Exposure Draft (ED) of its new standard as it applies to employees by the end of the next month, and to issue a final new standard by the end of this year.

The IASB is a London-based organization newly formed in 2001 that is committed to developing a single set of high-quality, global accounting standards. The IASB cooperates with national accounting standard-setting organizations such as the FASB in pursuit of this global convergence objective. Although the IASB's rule-making authority does not directly affect U.S. companies, the European Union (EU) is requiring all companies listed on European stock exchanges switch to "EU endorsed" IASB standards no later than 2005 (2007 for companies also listed in the U.S.)

IFRS 2 is comprised of three separate documents that consist of the actual "principles-based" standard itself (and related appendices), "implementation guidance," and the IASB's "basis for conclusions." The remainder of this letter summarizes the most pertinent provisions of the IASB's new standard.

Scope:	• IFRS 2 applies broadly to all EBC transactions with employees and nonemployees • There are no exceptions, other than for transactions covered by another standard (such as business combinations)
Effective Date and Transition:	• IFRS 2 is effective for all companies for annual periods beginning on or after January 1, 2005, with earlier application encouraged • Applies to "equity-settled" EBC granted after the November 7, 2002 release of ED 2 and not yet vested as of the effective date (application to EBC granted prior to this date is encouraged) • Applies to all "cash-settled" EBC outstanding as of the effective date, regardless of when granted (application to EBC settled prior to the effective date is encouraged) • Prior period comparative financial information is to be restated
Transactions with Nonemployees:	• EBC compensation cost is based on the "fair value" of goods or services received, as measured at the date of receipt and recognized [in an unspecified manner] over the expected vesting period (there is a rebuttable presumption that fair value of the goods or services can be estimated reliably)
Transactions with Employees:	• EBC compensation cost is based on the fair value of equity instruments granted, as measured at the date of grant and recognized [in an unspecified manner] over the expected vesting period (because it is typically not possible to estimate reliably the fair value of services received)
Equity-Settled EBC Transactions:	• Defined as EBC transactions that are intended by the company to be settled in the company's stock, such as stock options, employee stock purchase plans (ESPPs), and stock-settled stock appreciation rights (SARs), restricted shares/share units, and performance shares/share units • Compensation cost for "full-value" EBC (such as restricted/performance shares) is based on the market value of the underlying stock at the measurement date (date of grant for employee EBC), with appropriate adjustments for lack of dividends or restrictions on transfer after vesting • Compensation cost for "appreciation" EBC (such as stock options and stock-settled SARs) is estimated using an option pricing model taking into account at a minimum the typical inputs which include current stock price, exercise price, life of the option, expected stock price volatility, expected dividends, and risk-free interest rate • IFRS 2 does <u>not</u> explicitly state the type of option pricing model that should be used, but it implies the Black-Scholes-Merton formula may not be appropriate if it is important to measure the possibility of early exercise or the possibility that stock price volatility or other model inputs may vary over the option's life • Other option pricing model inputs (such as market conditions discussed below) that a "knowledgeable willing market participant" would consider may be used in estimating fair value, but no adjustment should be made for vesting conditions, reload features (reloads are treated separately as new grants), or factors that affect the option value from the employee's perspective only
Cash-settled EBC Transactions:	• Defined as EBC transactions that are intended by the company to be settled in cash or other assets rather than equity, such as cash-settled SARs and restricted/performance share units (in other words, "liabilities" measured by

reference to the company's stock price)

- Compensation cost for full-value EBC is based on the market value of the underlying stock, as measured at each reporting period until settlement (that is, "variable accounting" until award settlement)
- Compensation cost for appreciation EBC is estimated using the same option pricing methodology as for equity-settled EBC, but as measured at each reporting period until settlement (that is, variable fair value accounting until final measure of the liability at "intrinsic value" at settlement)
- Same treatment above applies if employee has choice of cash settlement, or if company has an obligation or exhibits a pattern of cash settlement

Vesting Conditions:

- Compensation cost is <u>not recognized</u> if EBC fails to vest because of a "service" or "performance" condition (defined as the completion of a specified period of service or attainment of a specified performance target, respectively)
- Compensation cost is <u>not reversed</u>, however, if EBC fails to vest because of a "market" condition (defined as a target share price upon which vesting or exercisability is conditioned); rather, market conditions are taken into account when estimating grant date fair value
- Compensation cost also is not reversed if a vested stock option expires unexercised (such as when the stock option is "underwater")

If Fair Value Cannot be Estimated:

- Compensation cost for all EBC is based on the award's "intrinsic value," as measured each reporting period until award settlement (that is, variable intrinsic value accounting until award settlement)

Award Modifications, Cancellations, and Settlements:

- At a minimum, compensation cost for equity-settled EBC is always recognized equal to the grant date fair value of the award, unless the award is forfeited pursuant to original service or performance vesting conditions (award modifications are not relevant for cash-settled EBC or EBC for which fair value cannot be estimated because these awards are subject to variable fair value/intrinsic value accounting, respectively)
- In addition, compensation cost is also recognized for any incremental fair value resulting from the modification, measured as the difference between the estimated fair value of the modified award and the original award at the modification date (there is no accounting consequence for modifications that result in "decremental" fair value)
- Any payment made upon cancellation or settlement of EBC is either accounted for as a reduction in equity (in the case of equity-settled EBC) or a settlement of liability (in the case of cash-settled EBC), except that any amount paid in excess of fair value at the settlement date is recognized as additional compensation cost

Treatment of Income Taxes:

- Compensation cost for EBC is generally recognized "net-of-tax" for awards that normally give rise to tax deductions
- If the deduction reported on the company's tax return is less than the amount of compensation cost recognized in its financial statements (such as when the option profit at exercise is less than fair value at grant), the tax effect of the difference increases income tax expense (and thus decreases net income)
- If the deduction reported on the company's tax return is more than the amount of compensation cost recognized in its financial statements (such as when the option profit at exercise exceeds fair value at grant), the tax effect of the difference is reported as an increase to equity

Footnote Disclosures:

- The disclosure requirements of IFRS 2 are substantively similar to those of FASB Statement 123, but generally provide for more specificity in regard to how the fair value of EBC was determined and how much compensation cost was recognized for equity-settled and cash-settled EBC transactions

As mentioned above, the provisions of IFRS 2 that deal with EBC transactions with employees are expected to be substantively similar to the FASB's ED scheduled to be released next month. The FASB's proposed new standard is expected to be effective for public companies on a "modified prospective" basis for fiscal years beginning after December 15, 2004, and for nonpublic companies on a "prospective" basis for fiscal years beginning after December 15, 2005. Further, the FASB is expected to permit nonpublic companies to account for EBC transactions using either fair value or intrinsic value methodology. Once the FASB releases a final standard and completes the remaining phases of its project dealing with EBC transactions with nonemployees and employee stock ownership plans (ESOPs), the IASB and FASB plan to undertake a final convergence project with the objective of eliminating any remaining differences in EBC transactions.

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General questions about this letter can be addressed to Thomas M. Haines in our Chicago office at 312-332-0190 or by email at tmhaines@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:

- November 5, 2003 – FASB Announces Planned Effective Date and Method of Transition for Stock Option Expensing Mandate And Reaches Further Convergence With IASB -- http://www.fwcook.com/alert_letters/11-5-03-FASB%20An%C9ing%20Mandate.pdf
- 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