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FASB Issues Exposure Draft on Share-Based Payment

The Financial Accounting Standards Board (FASB) on March 31, 2004 issued on schedule its Exposure Draft on amendments to FASB Statement No. 123 (Statement 123), referred to as "Share-Based Payment." Interested parties have until June 30, 2004 to submit written comments on the proposed standard. Following the comment period, the FASB plans to hold several public roundtable meetings on the east and west coasts to discuss issues with constituents. The FASB's project plan calls for release of a final standard on Share-Based Payment in the fourth quarter of 2004 to be effective January 1, 2005 for calendar year public companies.

Overview

In general, there are no surprises in the proposed standard. The "intrinsic value" method of accounting would be repealed (except in limited circumstances) and replaced with a requirement that generally all equity awards granted to employees be accounted for at "fair value." This fair value would be measured at grant for stock-settled awards, and at subsequent exercise or settlement for cash-settled awards. Fair value would be equal to the underlying value of the stock for "full-value" awards such as restricted stock and performance shares, and estimated using an option-pricing model with traditional inputs for "appreciation" awards such as stock options and stock appreciation rights. Compensation cost equal to these fair values would be recognized net-of-tax over the vesting or performance period only for awards that vest, but there are important exceptions for awards with "stock price" or "intrinsic value" performance criteria. Subsequent modifications to outstanding awards would result in incremental compensation cost if fair value is increased as a result of the modification. Thus, a value-for-value stock option "repricing" would not result in additional compensation cost.

The proposed standard is in substantial convergence with the International Accounting Standard Board's (IASB) final standard on Share-based Payment, except for transactions with nonemployees and nonpublic companies, and minor technical differences in regard to modifications, liabilities, and income tax effects. The proposed standard creates a "level playing field" for equity incentive design that is expected to result in the increased prevalence of stock-settled stock appreciation rights, performance-vesting awards, and the use of dividends (or dividend equivalents), and a corresponding decline in stock options (plain-vanilla, tax qualified, and reload) and employee stock purchase plans. The remainder of this letter summarizes the most pertinent provisions of the proposed standard.

Scope

Employees – The scope of the proposed statement is limited to share-based payment transactions with employees and nonemployee directors, both as defined in a manner similar to the guidance provided in FASB Interpretation No. 44. That is, employees are defined by reference to common law and federal payroll tax principles, and nonemployees directors must be elected by the company's shareholders.

<u>*Nonemployees*</u> – The proposed statement does not affect share-based payment transactions with nonemployees, such as independent contractors, advisory board members, and other nonemployee service providers. These transactions continue to be accounted for under the vesting date fair value provisions of Statement 123 and EITF Issue No. 96-18. The FASB intends to reconsider this issue in a later phase of its share-based payment project.

<u>*Employee Stock Ownership Plans (ESOPs)*</u> – The proposed statement does not affect share-based payment transactions with tax-qualified ESOPs, which continue to be accounted for under the provisions of AICPA Statement of Position (SOP) 93-6. The FASB also intends to reconsider this issue in a later phase of its share-based payment project.

<u>*Employee Stock Purchase Plans (ESPPs)*</u> – The proposed statement eliminates the noncompensatory exception for ESPPs, unless the share purchase terms are nondiscriminatory to employees and the same as offered to all shareholders. Thus, any preferential purchase discount (even 5 percent or less) results in fair value compensation cost under the proposed statement.

<u>Effective Date and Transition</u>

<u>*Public Companies*</u> – The proposed statement is effective for awards granted, modified, or settled in fiscal years beginning after December 15, 2004, with earlier application encouraged. The proposed statement also applies to the nonvested portion of awards outstanding as of the effective date (provided the awards were granted or modified in fiscal years beginning after the December 15, 1994 effective date of Statement 123), using previously estimated grant date fair values calculated for recognition or pro forma disclosures under Statement 123. Retroactive restatement of prior periods is prohibited because it could require companies to make estimates for an earlier period when it would be impractical to distinguish between information available at that time or information that arose subsequently, such as employee early exercise and post-vesting employment termination behavior. The pro forma disclosures currently required by Statement 123 as amended by FASB Statement No. 148 (Statement 148) would continue to be required until all presented periods are accounted for under the proposed standard. Importantly, these transition provisions apply to <u>all</u> companies, regardless of whether Statement 123 was previously adopted using the "prospective" transition method permitted under Statement 148.

<u>*Nonpublic Companies*</u> – The same effective date and transition provisions for public companies apply to nonpublic companies that previously adopted the fair value (as opposed to "minimum value") provisions of Statement 123 for recognition or pro forma disclosures. Conversely, nonpublic companies that previously used the minimum value method for recognition or pro forma disclosures would apply the proposed statement prospectively to awards granted, modified, or settled in fiscal years beginning after December 15, 2005 (with earlier adoption permitted), with no application to the nonvested portion of awards outstanding as of that effective date.

<u>Equity Versus Liability Awards</u>

<u>*Equity Awards*</u> – A share-based payment arrangement is classified as equity if the written or substantive terms of the award call for settlement solely in company stock. Examples of equity awards are stock options, ESPPs, stock-settled stock appreciation rights (SARs), restricted shares/share units, and performance shares/share units. Equity awards are not reclassified as liabilities merely because the company occasionally settles awards for cash or withholds shares to

satisfy minimum statutory tax withholding requirements, or because the employee effects a cashless exercise through an unrelated broker. However, equity awards may be reclassified as liabilities if the above conditions are violated (refer to *Liability Awards* below).

Liability Awards – A share-based payment arrangement is classified as a liability if the written or substantive terms of the award call for settlement in cash or other assets, or the award is classified as a liability under FASB Statement No. 150 (for example, mandatorily redeemable shares issued upon stock option exercise). Examples of liability awards are cash-settled SARs and restricted/performance share units (non-stock-denominated cash awards such as performance units are not accounted for as share-based payments). As suggested above, equity awards may be reclassified as liability awards if the company exhibits a pattern of cash settlement, withholds taxes in excess of minimum statutory rates, or permits a related broker to effect cashless exercises.

Compensation Cost for Equity Awards

In General – Compensation cost is based on the award's fair value at grant, less the amount (if any) paid by the award recipient. The date of grant occurs when there is a mutual understanding of the award's terms and all necessary authorizations are obtained.

Full-Value Awards – Compensation cost for full-value awards such as restricted stock and performance shares (or share units payable solely in stock) is based on the market value of the underlying stock at the date of grant. Dividends (if any) paid during the vesting or performance period are not recognized as additional compensation cost, unless the underlying awards are subsequently forfeited and the dividends are not repaid. Compensation cost for non-dividend-paying awards is reduced by the present value of estimated forgone dividends over the vesting period.

Appreciation Awards – Compensation cost for appreciation awards such as stock options or stock-settled SARs is estimated at grant date using an option-pricing model taking into account at a minimum the six traditional inputs (refer to *Option-Pricing Model Inputs* below), assuming observable market prices are not available. The proposed statement does not explicitly mandate a specific option-pricing model, but states that a "lattice" model such as a binomial model is preferable over a "closed-form" model such as the Black-Scholes-Merton formula. The lattice model is regarded as preferable for the following reasons:

- Allows for changes to model inputs over the contractual term of the option, such as changes in risk-free interest rates, stock-price volatility, and expected dividends
- Allows for estimates of employee early exercise patterns and post-vesting employment termination over the contractual term of the option, thereby providing a more accurate adjustment for nontransferability
- Allows for adjustments to fair value to account for the existence of market conditions (refer to *Market Conditions* below)

The FASB decided to regard as preferable, rather than mandate, the use of a lattice model because such models are not yet commercially available and companies may not yet have the necessary model input information. However, because the lattice model is regarded as preferable, once companies begin using it they generally may not revert to a closed-form model.

Option-Pricing Model Inputs – The proposed statement provides extensive guidance for companies when selecting option-pricing model inputs, as briefly summarized below:

Current stock price:	•	Market value of underlying stock on measurement date (grant date for equity awards and end of each reporting period until settlement for liability awards)
Exercise price of option:	•	At-the-money, premium, or discount exercise price inputs
Expected term of option:	•	Based on contractual term of option and effect of employee expected early exercise and post-vesting employment termination behavior (the FASB's implementation guidance states that the expected term must at least include the vesting period, and uses as an example an input referred to as a "suboptimal exercise factor"); expected term is a direct input in a closed-form model, but is inferred based on the output of a lattice model
Risk-free interest rate(s):	•	Implied yield(s) on U.S. Treasury zero-coupon issues, using yield curve over expected option term for lattice models and current yield with remaining term equal to expected option term for closed-form models (special guidance is provided for jurisdictions outside the U.S.)
Expected stock price volatility:	•	Generally based on historic price observations commensurate with contractual term for lattice models or expected term for closed-form models (as adjusted for supportable future expectations)
Expected dividends on stock:	•	May be input as either an expected yield or dollar amount, taking into account supportable future expectations based on publicly available information (use an input of zero for dividend-paying stock options and SARs)

When selecting model inputs, the FASB instructs companies to use an average of the range of estimates when no amount within the range in more or less likely to occur, and cautions companies that unadjusted historical data may not be appropriate if future expectations are reasonably expected to differ from past experience. In addition, the proposed standard provides guidance on the treatment of exotic design features, such as stock options with a reload feature or indexed, stepped, or look-back exercise price, restrictions on transfer after vesting, tandem awards, clawback features, and book value share purchase plans.

<u>Not Possible to Estimate Fair Value</u> – In the unlikely event that a company determines it is not possible to reasonably estimate fair value at grant date, the proposed statement requires equity awards to be accounted for at intrinsic value until award settlement (that is, variable intrinsic value accounting), even if fair value can be reasonably estimated subsequently.

Compensation Cost for Liability Awards

The proposed standard requires that liability awards be calculated at fair value using the same methodology as for a equity awards, except that fair value is remeasured at the end of each reporting period until award exercise or settlement (that is, variable fair value accounting). Thus, compensation cost for full-value awards is remeasured each period based on the market value of the underlying stock until award vesting or settlement. Likewise, compensation cost for appreciation awards is remeasured each reporting period using an option-pricing model until final measurement at intrinsic value at award exercise or settlement.

Vesting Conditions

In General – The proposed statement distinguishes between service, performance, and market conditions for purposes of determining (1) the fair value of an award, (2) the period over which compensation cost is recognized (refer to *Recognizing Compensation Cost* below), and (3) whether previously recognized compensation cost may be reversed if an award fails to vest. If a vesting condition is something other than a service, performance, or market condition (the proposed statement uses as an example vesting indexed to the value of a commodity), the share-based payment arrangement is classified as a liability award (taking into consideration the non-service/performance/market condition(s) in the estimate of fair value).

Service and Performance Conditions – A service condition is defined solely by reference to an employee rendering services to the company (including accelerated vesting in event of death, disability, or retirement). A performance condition is dependent on both the employee rendering services and the attainment (by the employee or company) of a specified performance target(s) defined solely by reference to the company's own operations, either on an absolute basis or relative to other companies (including an initial public offering or change in control). Service and performance conditions that affect vesting are not considered when estimating grant date fair value. Rather, previously recognized compensation cost is reversed if the service or performance conditions are not satisfied and the award is forfeited. Conversely, service and performance conditions that affect factors other than vesting (such as exercise price, number of shares, or contractual term) are considered when estimating grant date fair value by considering each possible outcome. For example, if the number of shares may double or the exercise price be halved based on a performance condition, the fair value of the award is estimated for each possible outcome and initially accrued based on the most probable outcome (refer to *Recognizing Compensation Cost* below).

Market Conditions – A market condition is defined as a condition affecting vesting or any other factor used in estimating fair value that relates to the attainment of a specified stock price or amount of intrinsic value (including, presumably, total shareholder return), either on an absolute basis or relative to other companies. Market conditions are always considered when estimating fair value. However, provided the requisite services are rendered (refer to *Recognizing Compensation Cost* below), previously recognized compensation cost is not reversed if the market conditions are not satisfied and the award is forfeited.

Recognizing Compensation Cost

Requisite Service Period – The proposed statement introduces the term "requisite service period" for determining the period over which compensation cost should be recognized. The requisite service period may be explicit, implicit, or derived, as follows:

Explicit:	• Explicitly stated in the award agreement
Implicit:	• May be inferred from service or performance conditions
Derived:	• Derived from valuation of a market condition when estimating fair value

The proposed standard provides complex guidance for determining the requisite service period, which may be deciphered as follows:

- If a vesting condition requires the performance of future services, the initial estimate of the requisite service period cannot be a prior period; for example, if nonvested awards are granted as consideration for a prior incentive payment (such as an annual bonus), compensation cost must be recognized over the future vesting period not the prior annual bonus period

- If vesting is based solely on a service condition, the initial estimate of the requisite service period is presumed to be the vesting period
- If service condition vesting may be accelerated by a performance condition that is probable of attainment, the initial estimate of the requisite service period is based on the shorter performance period (otherwise, vesting is based on the service period)
- If vesting is based on both market and service or performance conditions (that are probable of attainment), the initial estimate of the requisite service period is generally based on the longest measurement period
- If vesting is based on either market or service or performance conditions (that are probable of attainment), the initial estimate of the requisite service period is generally based on the shortest measurement period

Companies are to base initial accruals of compensation cost on the initial estimate of the requisite service period. If the initial estimate of the requisite service period is based on service or performance conditions, companies are to revise that estimate if subsequent information indicates a different measurement period is more appropriate. Conversely, if the initial estimate of the requisite service period is based on market conditions, that estimate is not to be revised unless the market conditions are satisfied prior to the end of the initial measurement period.

Accrual of Compensation Cost – Compensation cost is recognized beginning on the service inception date (which can occur before grant date, for example, if subsequent shareholder approval is required) over the requisite service period based on the number of awards that are expected to vest, with adjustments in later periods to the extent actual forfeitures differ from prior estimates. Compensation cost for awards with a "cliff" vesting schedule is recognized ratably over the requisite service period. Compensation cost for awards with a "graded" vesting schedule is recognized on an accelerated accrual basis (originally prescribed by FASB Interpretation No. 28) that assumes each vesting tranche is a separate award. That is, the ability to use straight-line recognition for awards with graded vesting is eliminated under the proposed statement.

Option Expires Unexercised – Previously recognized compensation cost is not reversed if a vested stock option expires unexercised, such as when the stock option is "underwater."

Award Modifications, Cancellations, and Settlements

Modifications – The proposed statement broadly defines a modification as any change to an award's terms, including number of shares, exercise price, transferability, settlement provisions, and vesting conditions. Also included as modifications are exchanges of awards or changes to award terms in conjunction with a business combination or an equity restructuring (such as a stock dividend, stock split, spinoff, rights offering, or large nonrecurring cash dividend). At a minimum, compensation cost is always recognized for the original grant date fair value of the award, unless at the modification date the original service or performance conditions are not expected to be satisfied. In addition, compensation cost is also recognized for any incremental fair value (or intrinsic value, if applicable) 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. Modifications that relax a vesting condition that was not probable of attainment at the modification date result in a final measure of compensation cost equal to the fair value of the award at the modification date.

Cancellations – Cancellation of an award accompanied by the concurrent grant of a replacement award (or other valuable consideration) is accounted for as a modification. Cancellation of a nonvested award for no consideration results in the recognition of previously measured but unrecognized compensation cost.

Settlements – The amount of cash or other assets paid to repurchase an equity award is accounted for as a reduction in equity, provided the repurchase amount does not exceed the fair value of the award at the repurchase date. Any excess of the repurchase price over the fair value of the award at repurchase is recognized as additional compensation cost. Settlement of a nonvested award results in the recognition of previously measured but unrecognized compensation cost.

Nonpublic Companies

The same fair value compensation cost provisions for public companies apply to nonpublic companies that previously adopted the fair value (as opposed to minimum value) provisions of Statement 123 for recognition or pro forma disclosures. However, for nonpublic companies that previously used the minimum value method for recognition or pro forma disclosures, the proposed statement permits these companies to choose between the fair value and intrinsic value methods when accounting for appreciation equity awards and liability awards (full-value equity awards continue to be accounted for based on fair value/intrinsic value at grant). If the intrinsic value method is chosen, all appreciation equity awards and liability awards are remeasured at each reporting period until award exercise or settlement (even if the company subsequently elects the fair value method). Because the fair value method is regarded as preferable, once nonpublic companies begin using it they may not revert to the intrinsic value method.

Income Taxes

The proposed statement requires fair value (or intrinsic value) compensation cost to be recognized net-of-tax for share-based payment arrangements that normally give rise to tax deductions (such as nonqualified stock options). Conversely, compensation cost is not tax effected for awards that normally are not tax deductible, such as the exercise of an incentive stock option (ISO). 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 <u>less</u> than fair value at grant), the effect of the tax deficiency increases income tax expense (and thus decreases reported net income). If the deduction reported on the company's tax return is <u>more</u> 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 effect of the excess tax benefit is reported as an increase to equity on the balance sheet and as both a financing cash receipt and operating cash payment on the statement of cash flows.

Footnote Disclosures

The proposed statement makes several notable changes to the footnote disclosures that existed under Statement 123 and predecessor rules, including the following:

- Stock option grant, exercise, forfeiture, etc. activity for the most recent year only (not prior 3 years), and elimination of "range of exercise price" disclosure (weighted-average exercise price disclosure retained)
- Total intrinsic value of stock options exercised and shares vested during the year, and aggregate intrinsic value of stock options outstanding and currently exercisable at year end

- Total unrecognized compensation cost of nonvested awards, and the future period over which recognition is expected to occur (including compensation cost that is capitalized as part of an asset)
- More specificity in regard to the range of assumptions used in a lattice option-pricing model
- Amount of option proceeds received and tax benefits recognized during the year (unless disclosed in the statement of cash flows)
- Amount of cash used to settle equity awards (unless disclosed in the statement of cash flows)
- Policy for repurchasing shares in conjunction with share-based payment arrangements (if such policy exists), including number of shares expected to be repurchased in the next period

The objectives of the new disclosures are to enable financial statement users to understand the nature and general terms of share-based payment arrangements, the method of estimating fair value, the effect of compensation cost on the income statement and balance sheet, and resulting cash flow effects.

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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:

Date	Title	Website Link
February 26, 2004	IASB Issues Final Standard on Share-Based Payment	http://www.fwcook.com/alert_letters/2-26-04-IASB%20Issues%20Final%20Standard%20on%20Share-based%20Payment.pdf
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