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New York • Chicago • Los Angeles

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FASB Delays Timetable on Stock Compensation Project

But Project Derailment Still Not Likely

Since our last writing on this subject, the Financial Accounting Standards Board (FASB) has met five times to deliberate key issues on its project to require an accounting cost for employee stock options. This letter is intended to update our readers on the most substantive developments occurring during these meetings.

> The FASB on September 10, 2003 tentatively decided to delay its stock compensation project timetable by one quarter, with the release of an Exposure Draft and final standard now most likely to occur in the first and third quarters of 2004, respectively. The FASB also decided to address stock-based transactions with nonemployees and employee stock ownership plans (ESOPs) in a later "second phase" of the project. Separately, the International Accounting Standards Board (IASB) has deferred the anticipated release of its final standard on "Share-based Payment" to the first quarter of 2004.
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> Notwithstanding these delays, the FASB and IASB remain committed to issuing substantively similar standards requiring an expense for employee stock options based on option pricing models that are more sophisticated and flexible than the traditional Black-Scholes model, such as the binomial or other "lattice" or "tree" type models. For companies issuing U.S. financial statements, a mandated option expense now appears most likely to occur in some form of "retroactive" manner beginning in 2005.

Other substantive decisions tentatively reached by the FASB over the summer include the following:

- FASB will retain the FAS 123 model of crediting/debiting excess tax benefits/liabilities directly to equity on the balance sheet rather than the proposed IASB approach of flowing all income tax effects through the income statement; this is a rare instance in the project where the FASB and IASB have not yet reached "convergence"
- FASB will not allow nonpublic companies to use the "minimum value" method to value stock options; all companies must compute compensation cost using the fair value approach
- FASB will require recognition of compensation cost for all employee stock purchase plans (ESPPs) with terms more favorable than those offered to shareholders generally; that is, <u>no</u> purchase discounts will be permitted without an accounting cost

- FASB will retain the FAS 123 definition of "grant date" so that awards made subject to shareholder approval will not be deemed granted until approval is obtained (resulting in "variable" award accounting during the interim period)
- FASB will retain the FAS 123 guidance for "cash-settled" awards so that if past practice indicates a pattern of cash settlement, the award should be accounted for as a liability
- FASB will retain the FIN 44 guidance for stock-for-tax withholding transactions; that is, withholding will be permitted only up to *minimum statutory* federal, state, and payroll tax withholding rates (otherwise the award presumably will be accounted for as a liability)
- FASB will retain the EITF 00-23 (Issue 48) guidance for broker-assisted cashless exercises; that is, there will be no accounting consequence if the broker is unrelated to the company and the employee makes a valid exercise and is legal owner of the option shares
- FASB will adopt the IASB guidance for accounting for liabilities; that is, interim "fair value" accruals for cash SARs (rather than "intrinsic value" accruals) based on the FIN 28 attribution methodology
- FASB decided that the term "modification" should be broadly interpreted to include <u>all</u> changes in terms and conditions of an award, including quantity, price, transferability, settlement provisions, vesting requirements, and short-term "inducements" to exercise; any incremental value resulting from a modification should be recognized as additional compensation cost (FASB did not decide on <u>how</u> to measure that incremental value)
- FASB will retain the FAS 123 treatment for "antidilution provisions" (that is, no accounting consequence for adjustments related to stock splits, etc.) and cash settlements of awards accounted for as "equity" as opposed to "liability" awards (that is, no incremental cost if amount of cash paid is equal to award's current fair value)
- FASB will retain the FAS 123 guidance permitting companies to reduce grant date fair value for awards that continue to be contractually or governmentally restricted after the shares vest, such as when the underlying stock is not registered
- FASB will require variable award accounting for the entire life of the award when it is not possible to reasonably estimate fair value at grant date (FAS 123 cites as examples certain exotic features such as stock options with an "indexed" exercise price or convertible instruments where the conversion ratio is based on the outcome of future events)
- FASB will retain the FAS 123 guidance for stock options with a "reload" feature; that is, every reload is treated as a separate grant (unlike the IASB proposal where an attempt would be made to value the reload feature at the grant date of the original stock option)
- FASB decided that the "reconveyance" of an award back to the company results in <u>income</u> equal to the lesser of (1) the fair value of the reconveyed award, or (2) the amount of previously recognized compensation cost
- FASB will retain the FAS 123 treatment of dividends; that is, stock options should be valued using a dividend input of zero and there is no incremental cost for dividend-paying full value awards, unless the awards do not vest
- FASB will retain the FAS 123 provision that disallows the reversal of previously accrued compensation cost if a stock-based award is forfeited because of failure to meet "stock price" or "intrinsic value" performance goals

- FASB will clarify that FAS 123 is intended to apply broadly to all types of equity-based arrangements, including those used by unincorporated entities
- FASB will identify which FIN 44/EITF Issue 00-23 implementation issues are applicable under FAS 123 fair value rules

A brief summary of the significant differences between FAS 123 and the IASB proposal (ED2) and the FASB's tentative conclusions to date is summarized 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:

- 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)*
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)*
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)*
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	Not yet fully deliberated; additional guidance to be provided in computing stock price volatility *(September 10, 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)*