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FASB Releases Exposure Draft on Amendments to Statement 123

The Financial Accounting Standards Board (FASB) on October 4, 2002 issued an anticipated Exposure Draft (ED) amending the "transition and disclosure" provisions of FASB Statement No. 123 (Statement 123).[1] Statement 123, issued in October 1995, is the FASB's "preferable method" of accounting for stock-based compensation that requires a "grant date fair value" (i.e., Black-Scholes) compensation expense for employee stock options. The ED was issued in connection with a "limited-scope fast-track" project undertaken by FASB this summer in response to concerns raised about the lack of "comparability and consistency" of financial statements following the sudden adoption of Statement 123 by many companies. The proposed amendments to Statement 123 are intended to address two primary concerns:

> First, although over 100 companies have adopted Statement 123 at our last count, the vast majority of publicly traded companies appear to have taken a "wait and see" posture by remaining under the provisions of APB Opinion No. 25 (Opinion 25). The ED attempts to mitigate this lack of transparency by moving pro forma net income and earnings per share (EPS) disclosures required under Statement 123 from the stock compensation footnote (which is often criticized as being "buried" in the back of the financial statements) to a tabular and much more prominent location in the "Summary of Significant Accounting Policies" footnote (which is usually the initial footnote of the financial statements). Importantly, the proposed tabular disclosures would be required for *annual* as well as *interim* financial statements.
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> Second, for the 100+ companies that have voluntarily adopted Statement 123, existing transition provisions (which FASB stresses were appropriate at the time Statement 123 was originally issued) require these companies to apply the new rules only to awards granted, modified, or settled after the start of the fiscal year in which Statement 123 is adopted. The ED attempts to mitigate the ramp-up effect of this "prospective application" by allowing companies that *voluntarily* adopt Statement 123 to do so in an expedited manner.

With one exception, all proposed amendments to Statement 123 in the ED would be effective for fiscal years ending after December 15, 2002 (i.e., for calendar year 2002 financial statements), with earlier application "permitted" if feasible for the alternative transition provisions and "encouraged" in regard to the enhanced disclosure rules. The exception is that the enhanced tabular disclosures required for interim financial statements would be effective for interim

[1] A copy of the ED, titled *Accounting for Stock-Based Compensation-Transition and Disclosure,* is available on the FASB's website at www.fasb.org

periods beginning after December 15, 2002 (i.e., for first quarter 2003 interim reports for calendar year companies), again with earlier application encouraged. Interested parties have until November 4, 2002 to submit written comments in regard to the ED, and the FASB intends to issue a final standard by year end.

Implications for Companies Remaining Under Opinion 25

The proposed new transition provisions prescribed by the ED are *not* relevant for companies remaining under Opinion 25, other than our caveat that FASB likely would not offer a transition *choice* if it later mandates all companies to adopt Statement 123. The proposed new disclosure rules *are* applicable to all companies, however, and require Opinion 25 companies to affirmatively acknowledge that stock compensation is accounted for under the provisions of Opinion 25 and present the following tabular information prominently in the Summary of Significant Accounting Policies footnote (or its equivalent) of the financial statements:

	Year Ended December 31		
	2003	2002	2001
Net income, as reported	$	$	$
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	$	$	$
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards,* net of related tax effects	$(_________)	$(_________)	$(_________)
Pro forma net income	$	$	$
Earnings per share:			
Basic – as reported	$	$	$
Basic – pro forma	$	$	$
Diluted – as reported	$	$	$
Diluted – pro forma	$	$	$

* "All awards" refers to awards granted, modified, or settled in fiscal periods beginning after December 15, 1994 (tabular disclosure is reproduced from illustrative guidance in the ED)

In the presentation of pro forma diluted EPS, companies are reminded that the calculation of "assumed proceeds" under the "treasury stock method" should include measured but unrecognized compensation cost and the excess tax benefits credited to paid-in capital as determined under Statement 123 (not Opinion 25).

The intended effect of the above disclosures is that compensation cost for stock options would become fully transparent for all companies, regardless of the method used to account for stock compensation (i.e., either Statement 123 or Opinion 25) or the transition approach elected to adopt Statement 123 (discussed below).

Implications for Companies Adopting FAS 123

The proposed new transition provisions prescribed by the ED for companies voluntarily adopting Statement 123 have the twofold objectives of (1) increasing financial statement transparency by allowing companies to report the effects of Statement 123 on an accelerated basis, and (2) avoiding the creation of a disincentive for more companies to adopt Statement 123. To this end, the ED would permit companies that voluntarily adopt Statement 123 to do so using one of three means:

> First, companies would be permitted to apply Statement 123 *prospectively* to all awards granted, modified, or settled after the beginning of the fiscal year in which Statement 123 is adopted. This is the prospective transition approach prescribed under the existing provisions of Statement 123. Under this approach, reported and pro forma net income and EPS would differ each period until Statement 123 is fully phased in for all outstanding nonvested awards.
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> Second, companies could apply the effects of Statement 123 prospectively as in the first alternative above, *plus retroactively* to all outstanding nonvested awards granted, modified, or settled in fiscal years beginning after December 15, 1994. Under this approach, reported and pro forma net income and EPS would differ each period prior to adoption, but would be the same for the period of adoption and all periods thereafter.
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> Third, companies could apply the effects of Statement 123 both prospectively and retroactively as in the second alternative above, *plus restate* all prior periods presented in a consistent manner. Under this approach, reported and pro forma net income and EPS would be the same for all periods presented.

Companies electing to transition to Statement 123 under the second or third alternatives above may need to report an adjustment to additional paid-in capital in the period of change to account for differences in the "carrying amounts" of unearned or deferred compensation (contra-equity accounts), stock-based compensation liabilities, and related deferred tax accounts that exist between Statement 123 and Opinion 25.

The proposed new disclosure rules prescribed by the ED would require Statement 123 companies to affirmatively acknowledge that stock compensation is accounted for under the provisions of Statement 123 and identify the transition method used to adopt Statement 123. In addition, companies choosing either of the first two alternatives for transitioning to Statement 123 would be required to present the same tabular disclosures discussed above for Opinion 25 companies for each period that outstanding nonvested awards are accounted for under Opinion 25.

What is Yet to Come

The International Accounting Standards Board (IASB) is scheduled to release its equivalent of an ED on accounting for "share-based payment" in the fourth quarter of this year. The IASB's ED is expected to call for grant date fair value compensation cost for stock options and awards beginning in 2004. The IASB's compensation cost methodology is similar to that of Statement 123, but there are some notable differences. The FASB plans to issue an "Invitation to Comment" concurrent with the release of the IASB's ED summarizing the proposal and key differences with Statement 123. The FASB then intends to consider in early 2003 whether further "convergence" of accounting standards for stock compensation is appropriate, including presumably whether to require *all* companies to expense employee stock options.

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General questions about this letter may be addressed to Thomas Haines at (312) 332-0910 or 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:

- 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