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FASB Releases Final Standard on Accounting for Stock-Based Compensation

The Financial Accounting Standards Board's (FASB) decade-long project on accounting for stock-based compensation reached an anticlimactic finale on October 23, 1995 with the release of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (FAS 123).

> The compromise final standard is substantively similar to that of the draft of the final standard (draft standard) issued earlier this year, with generally only minor changes in the form of technical clarifications and wording revisions. FAS 123 *encourages* companies to recognize compensation cost for virtually all employee stock-based awards, but *permits* companies to remain under the generally more favorable provisions of Accounting Principles Board Opinion No. 25 (APB 25). Companies adopting the compensation cost provisions of FAS 123 must do so for all future grants (that is, there is no ability to pick one standard for stock options and choose the other for performance grants), and any election to do so is permanent (that is, there is no ability to revert back to APB 25). Regardless of which method is used to recognize compensation cost, *all* companies are subject to the expanded footnote disclosure rules of the new standard effective for 1996 financial statements. In addition, companies remaining under the guidance of APB 25 must disclose, for all stock-based awards granted after 1994, what the impact on net income and earnings per share would have been had it adopted the cost recognition provisions of FAS 123.

Background[1]

The release of FAS 123 comes less than six months after issuance of the draft standard, and less than one year after the FASB's concession to "encourage" rather than "require" companies to adopt the compensation cost provisions of the new standard. The alacrity with which the stock-based compensation project was concluded is indicative of the FASB's desire to reach closure on what had become an extraordinarily contentious issue. Indeed, background information provided in the final standard indicates that the FASB received more than 2,700 letters of comment over the course of the project, and devoted more than 45 Board and Task Force meetings since 1992 to the development of the new accounting standard. During the final

1 Refer to our letter dated May 26, 1995 for a detailed summary of the draft standard.

months of the project, the FASB met on several occasions to address comment letters and resolve open issues with respect to the draft standard. FAS 123 was finally ratified at the June 26, 1995 Board meeting by the minimum requisite 5-2 member vote.

Scope

FAS 123 is applicable to virtually all employee and nonemployee compensatory transactions in which stock or other equity instruments are awarded, or in which liabilities with respect to such awards are incurred. The new standard is *not* applicable to employee stock ownership plans (ESOPs), or to certain broad-based employee stock purchase plans with minimal "option" features or purchase discounts (the final standard prescribes a safe-harbor discount of 5 percent or less). The recognition provisions of the new standard are *elective* for employee transactions falling within the scope of APB 25 (and, in practice, certain nonemployee transactions with outside directors and independent contractors discussed below), and are *mandatory* for all other nonemployee transactions. The disclosure provisions of FAS 123 are mandatory for all employee and nonemployee transactions, with additional disclosures required for companies accounting for employee awards under APB 25.

During stock project deliberations the FASB became concerned that, in practice, companies were inappropriately extending the scope of APB 25 to cover nonemployee transactions with outside directors and independent contractors. The FASB concluded that the issue was outside the scope of FAS 123, however, and deferred final judgment to a later date. It appears, therefore, that for the present companies may continue to account for outside director and independent contractor stock-based awards under the provisions of APB 25.

Effective Dates

There are three separate effective dates for the application of FAS 123, the first two of which remain the same as those proposed under the draft standard. First and foremost, the financial statement footnote disclosure provisions applicable to all companies are effective for fiscal years beginning after December 15, 1995, unless the recognition provisions of the new standard are adopted for an earlier year. For the vast majority of companies expected to remain under APB 25, the pro forma impact of the new standard on net income and earnings per share must include all stock-based awards granted in fiscal years beginning after December 31, 1994. Thus, calendar year companies not adopting the new standard must first comply with the new disclosure rules for 1996 annual reports to be issued in 1997, and must include all stock-based awards granted in 1995 and 1996.

Second, the cost recognition provisions of FAS 123 may be adopted for employee stock-based transactions at any time after the October 23, 1995 issuance date. For the relatively few companies expected to do so, compensation cost would be recognized in accordance with the new rules for all stock-based awards granted after the start of the fiscal year for which the election is made. Awards granted in prior fiscal years would continue to be accounted for under APB 25, unless they are subsequently modified or settled in cash. An election to adopt FAS 123 is irrevocable, and is applicable to all types of stock-based awards.

The third and final effective date, which applies to nonemployee transactions falling outside the scope of APB 25 (and, in practice, certain nonemployee transactions with outside directors and independent contractors), was not originally included in the draft standard. This effective date requires the recognition and disclosure provisions of FAS 123 to be applied to all nonemployee stock-based *transactions* occurring after December 15, 1995.

Footnote Disclosure[2]

The financial statement footnote disclosure provisions of FAS 123 supersede those prescribed in APB 25, and thus are applicable to all companies regardless of which standard is used to recognize compensation cost. In addition, companies which continue to recognize compensation cost pursuant to APB 25 must disclose for each year there is an income statement the pro forma impact of the new standard on net income and, if presented, on earnings per share. The disclosure requirements are essentially the same as those proposed in the draft standard, and are briefly summarized as follows:

General Plan/Award Terms:	• General description of each stock-based compensation plan • Vesting requirements • Maximum option term • Number of shares authorized for awards
Specific Award Information (for each year an income statement is provided):	• Number and weighted-average exercise price of options: (1) outstanding at the beginning and end of the year, (2) exercisable at the end of the year, and (3) granted, exercised, forfeited, and expired during the year • Weighted-average grant-date fair value of options granted during the year, with separate disclosure (including the related weighted-average exercise price) for "out-of-the-money," "at-the-money," and "in-the-money" options • Number and weighted-average grant-date fair value of equity instruments other than stock options granted during the year, such as "unvested" stock[3] • Method and assumptions used to calculate the fair value of options, including the weighted-average risk-free interest rate, expected life, expected stock-price volatility, and expected dividends • Total compensation cost recognized in the income statement • Any significant modifications to outstanding awards
Outstanding Stock Options (at most recent fiscal year end):	• Range of exercise prices and weighted-average exercise price • Weighted-average remaining contractual option term • Segregate information into meaningful exercise price ranges if there is a significant variation in exercise prices (the final standard suggests a range in excess of 150 percent)

In addition to the above requirements, FAS 123 requires companies to disclose the method used to account for stock-based awards (either FAS 123 or APB 25) in the "summary of significant accounting policies" section of the financial statements. Companies may also be required to alert financial statement readers that, during the initial phase-in period, the impact of the new standard on net income may not be representative of future years because of the exclusion of unvested pre-effective date grants.

[2] Refer to the Attachment for a summary of income statement and footnote disclosure implications for various grant types under APB 25 and FAS 123.

[3] The final standard uses the term " unvested" stock to describe awards which are subject to service- or performance-related contingencies, such as restricted stock or performance shares.

Calculation of Compensation Cost[4]

The calculation and recognition of compensation cost under FAS 123 remains essentially unchanged from the methodology proposed in the draft standard. In general, compensation cost is equal to a stock-based award's "fair value" at grant, less the amount (if any) paid by the award recipient. The final standard prescribes special rules for instances where fair value cannot be reasonably calculated at the date of grant. Compensation cost is generally recognized ratably over the award's vesting period, except for certain stock options with "graded" vesting schedules which may be subject to an accelerated accrual methodology. Compensation cost is generally *not* recognized for stock-based awards which do not vest, unless the forfeiture is due to the expiration of unexercised vested stock options or the failure to satisfy certain "stock price" or "intrinsic value" performance conditions. Lastly, compensation cost is generally recognized "net-of-tax" for stock-based awards which normally give rise to tax deductions (such as nonqualified stock options), but is not tax affected for awards which normally are not tax deductible (such as incentive stock options).

Fair value for unvested stock is equal to the fair market value of "vested" stock on the date of grant. Dividends (if any) paid during the vesting period are not recognized as additional compensation cost, unless the underlying awards are subsequently forfeited. Fair value for non-dividend-paying awards is reduced by the present value of any forgone dividends over the vesting period.

Fair value for stock options granted by a public company is calculated using an option-pricing model (the final standard suggests Black-Scholes or a binomial model) that takes into account at grant date the following six variables:

Fair Market Value Of Stock:	• Based on actual data
Exercise Price Of Option:	• Based on actual data
Expected Life Of Option:	• Generally based on weighted-average data for aggregate grant, or on more detailed data about employees' past exercise behavior
Expected Stock-Price Volatility:	• Generally based on historic data for expected life of option, and adjusted for future expectations (based on public data) as appropriate
Expected Dividends On Stock:	• Generally based on historic data for expected life of option, and adjusted for future expectations (based on public data) as appropriate; dividend-paying stock options must use a dividend input of zero
Risk-Free Interest Rate:	• Generally based on rate currently available for zero-coupon U.S. government issues with remaining term equal to expected life of option

Fair value for stock options granted by a nonpublic company is determined using the "minimum value" model which excludes stock-price volatility, and which is calculated either by simple present value techniques or by using an option-pricing model. Consistent with the draft standard, no "discounts" or "haircuts" from fair value are permitted for the nontransferability and forfeiture restrictions typically imposed on employee stock options.

[4] Refer to the Attachment for a summary of income statement and footnote disclosure implications for various grant types under APB 25 and FAS 123.

Fair value for stock-based awards which require cash settlement is equal to the amount of cash paid, with interim accruals based on changes in stock price between grant date and payment date. In addition, FAS 123 provides extensive guidance with respect to the calculation of fair value for stock-based awards with unique or complex features (such as "indexed" or "reload" stock options), and for awards which are subsequently modified or settled in cash.

Retrospect

FAS 123 is an impressive and complex document, and reflects appropriately the time and resources devoted by the FASB towards its development. At 146 pages in length, the new standard is longer than such other recent complex standards as FAS 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions" and FAS 109 "Accounting for Income Taxes."

Yet the issuance of FAS 123 is not likely to provide closure with respect to the divisive issues surrounding stock-based compensation. The FASB already acknowledges it must address the scope of APB 25's application to nonemployee awards, and the Emerging Issues Task Force (EITF) must now provide guidance under both stock-based accounting standards. The fundamental *elective* provisions of the final standard are apparently not subject to further debate, however, as the FASB acknowledged in writing that it has no intention of revisiting this contentious issue in the foreseeable future.

From a compensation practitioner's perspective, the culmination of the stock project is a bittersweet event. On one hand, companies may remain under the provisions of APB 25 and thereby avoid recognizing compensation cost for most stock option awards. On the other hand, the inherent bias of APB 25 against performance-vesting awards remains intact, and the accounting burden for stock-based awards is notably increased because companies must now comply with two separate standards.

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This letter represents our understanding of FAS 123, based on our reading of the final standard and on Fred Cook's involvement as a member of the FASB's Task Force on stock-based compensation. Different interpretations are possible and may evolve as the FASB and EITF provide additional guidance with respect to the final standard. Companies interested in interpretations specific to their own practices should consult their accounting staff and public auditors. General questions may be addressed to Tom Haines in our Chicago office at (312) 332-0910, or to any other member of our firm.

Grant Type Comparison
of APB 25 Versus FAS 123
Impact on Income Statement and Footnote Disclosure

	Impact on Net Income		**FAS 123 Impact on Pro Forma Footnote Disclosure***
Grant Type	**APB 25**	**FAS 123**	
Incentive Stock Options (ISOs):	• Compensation cost *not* recognized for options granted ‘‘at-the-money”	• Grant date fair value recognized as compensation cost over vesting period • Compensation cost *not* tax affected	• Reported net income and EPS reduced for compensation cost
Nonqualified Stock Options (NQSOs):	• Compensation cost *not* recognized for options granted ‘‘at-the-money”	• Grant date fair value recognized as compensation cost over vesting period • Compensation cost is tax affected	• Reported net income and EPS reduced for compensation cost (net of tax)
‘‘Reload’’ Stock Options:	• Compensation cost *not* recognized for reload options, provided that (1) options are granted ‘‘at-the-money,” and (2) shares tendered in stock-for-stock exercise are ‘‘mature,’’ i.e., held for at least six months	• Grant date fair value recognized as compensation cost over vesting period *for each reload grant*	• Reported net income and EPS reduced for compensation cost (net of tax)
Performance Stock Options:	• Compensation cost *not* recognized if options ultimately vest regardless of performance contingencies • Otherwise, ‘‘variable-	• Grant date fair value recognized as compensation cost over vesting period, with appropriate adjustments for forfeitures caused by performance contingencies (other than ‘‘stock	• Reported net income and EPS either increased or decreased to extent compensation cost (net of tax) is less than or greater than that of APB 25, respectively

* Represents the impact of FAS 123 on net income and earnings per share (EPS) for companies *not* adopting the compensation cost recognition provisions of FAS 123; FAS 123 calculations are limited to stock-based awards granted in fiscal years beginning after December 15, 1994.

Grant Type	Impact on Net Income: APB 25	Impact on Net Income: FAS 123	FAS 123 Impact on Pro Forma Footnote Disclosure*
	plan'' mark-to-market compensation cost recognized up to attainment of performance criteria	(other than ''stock price'' or ''intrinsic value'' contingencies)	respectively
''Premium'' Stock Options:	• Compensation cost *not* recognized for options granted ''out-of-the-money''	• Grant date fair value recognized as compensation cost over vesting period, with appropriate option-pricing model inputs for premium exercise price	• Reported net income and EPS reduced for compensation cost (net of tax)
''Discount'' Stock Options:	• ''Fixed-plan" compensation cost recognized over vesting period, equal to discount at grant date	• Grant date fair value recognized as compensation cost over vesting period, with appropriate option-pricing model inputs for discount exercise price	• Reported net income and EPS either increased or decreased to extent compensation cost (net of tax) is less than or greater than that of APB 25, respectively
''Indexed'' Stock Options:	• ''Variable-plan" mark-to-market compensation cost recognized up to establishment of exercise price	• Grant date fair value recognized as compensation cost over vesting period, with appropriate option-pricing model inputs for stock-price volatility and dividends	• Reported net income and EPS either increased or decreased to extent compensation cost (net of tax) is less than or greater than that of APB 25, respectively
Stock Options With Dividends:	• Compensation cost *not* recognized for options, provided that the dividends are not deemed to change either the number of shares granted or the exercise price • Amount of dividends	• Grant date fair value recognized as compensation cost over vesting period, with appropriate option-pricing model inputs for dividends	• Reported net income and EPS reduced to extent compensation cost (net of tax) exceeds that of APB 25

* Represents the impact of FAS 123 on net income and earnings per share (EPS) for companies *not* adopting the compensation cost recognition provisions of FAS 123; FAS 123 calculations are limited to stock-based awards granted in fiscal years beginning after December 15, 1994.

Grant Type	Impact on Net Income		FAS 123 Impact on Pro Forma Footnote Disclosure*
	APB 25	FAS 123	
	credited recognized as compensation cost in period credited		
Stock Appreciation Rights (SARs) Paid in Stock:	• ‘‘Variable-plan” mark-to-market compensation cost recognized up to exercise of SAR	• Grant date fair value recognized as compensation cost over vesting period	• Reported net income and EPS either increased or decreased to extent compensation cost (net of tax) is less than or greater than that of APB 25, respectively
Stock Appreciation Rights (SARs) Paid in Cash:	• ‘‘Variable-plan” mark-to-market compensation cost recognized up to exercise of SAR	• Variable mark-to-market compensa-tion cost recognized up to exercise of SAR	• Reported net income and EPS should *not* change, because com-pensation cost is calculated the same under APB 25
Performance Shares Paid in Stock:	• ‘‘Variable-plan” mark-to-market compensation cost recognized over earnout/vesting period	• Grant date fair value recognized as compensation cost over earnout/vest-ing period • Fair value reduced to extent dividends not credited over earn-out/vesting period	• Reported net income and EPS either increased or decreased to extent compensation cost (net of tax) is less than or greater than that of APB 25, respectively
Performance Shares Paid in Cash:	• ‘‘Variable-plan” mark-to-market compensation cost recognized over earnout/vesting period	• Variable mark-to-market compensation cost recognized over earn-out/vesting period	• Reported net income and EPS should *not* change, because compensation cost is calculated the same under APB 25
Restricted Stock, Performance	• ‘‘Fixed-plan” compensation cost	• Grant date fair value recognized as	• Reported net income and EPS should *not*

* Represents the impact of FAS 123 on net income and earnings per share (EPS) for companies *not* adopting the compensation cost recognition provisions of FAS 123; FAS 123 calculations are limited to stock-based awards granted in fiscal years beginning after December 15, 1994.

Grant Type	Impact on Net Income		FAS 123 Impact on Pro Forma Footnote Disclosure*
	APB 25	FAS 123	
Accelerated Restricted Stock (PARs), and Restricted Stock Units Paid in Stock:	recognized over vesting period, equal to fair market value of stock at grant date	compensation cost over vesting period • Fair value reduced to extent dividends not credited over earn-out/vesting period	change (unless divi-dends not credited), because compensation cost is calculated the same under APB 25
Restricted Stock Units Paid in Cash:	• ‘‘Variable-plan” mark-to-market compensation cost recognized over vesting period	• Variable mark-to-market compensa-tion cost recognized over vesting period	• Reported net income and EPS should *not* change, because com-pensation cost is calculated the same under APB 25
Employee Stock Purchase Plans:	• Compensation cost *not* recognized for stock purchase plans, provided that the ‘‘noncompensatory plan’’ requirements are satisfied	• Grant date fair value recognized as compensation cost over vesting period, unless the plan (1) has minimal ‘‘option’’ features (2) has a relatively small purchase discount, e.g., 5 percent or less, and (3) is generally available to all employees on an equitable basis • Special adjustments to fair value for purchase plans with ‘‘look-back” features • Compensation cost *not* tax affected for tax-qualified plans, but is tax affected for nonqualified plans	• Reported net income and EPS reduced for compensation cost (net of tax for nonqualified plans)

* Represents the impact of FAS 123 on net income and earnings per share (EPS) for companies *not* adopting the compensation cost recognition provisions of FAS 123; FAS 123 calculations are limited to stock-based awards granted in fiscal years beginning after December 15, 1994.

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