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FASB Releases Invitation to Comment on IASB Share-based Payment Exposure Draft

The Financial Accounting Standards Board (FASB) on November 18, 2002 released an "Invitation to Comment" in response to the much anticipated issuance on November 7, 2002 of the International Accounting Standards Board's (IASB) Exposure Draft on accounting for "Share-based Payment."[1] The purpose of the Invitation to Comment is to educate the FASB's constituents about, and solicit feedback on, the similarities and differences between the IASB proposal and the provisions of FASB Statement No. 123 (Statement 123). The FASB intends to use this feedback beginning early in 2003 when, in the spirit of "international convergence of high-quality accounting standards," it considers whether changes should be made to Statement 123, including presumably the ability to account for employee stock compensation under the provisions of APB Opinion No. 25 (Opinion 25).[2] Interested parties have until February 1, 2003 to submit written comments to the FASB in regard to the 30+ issues identified in the Invitation to Comment.

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 other 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 that all companies listed on European stock exchanges switch to IASB standards no later than 2005 (2007 for companies also listed in the U.S.).[3] The proposed International Financial Reporting Standard (IFRS) on Share-based Payment is only the second Exposure Draft released since the IASB's inception. The IASB proposal is conceptually similar to Statement 123 in that both standards acknowledge stock-based compensation is valuable and should be recognized as compensation cost equal to the award's "fair value" (generally, calculated at grant date for employee awards) over the period services are received (generally, the vesting period for employee awards). However, the IASB proposal differs from Statement 123 in several significant respects, including the following:

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[1] A copy of the FASB's Invitation to Comment, titled *"Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, Accounting for Stock-Based Compensation, and its Related Interpretations, and IASB Proposed IFRS, Share-based Payment,"* is currently available under nine separate files on the FASB's website at www.fasb.org; a copy of the IASB's Exposure Draft, titled "*Share-based Payment*," also is currently available under three separate files on the FASB's website as part of the Invitation to Comment, and also on the IASB's website at www.iasb.org.uk.

[2] Opinion 25 is not analyzed in the Invitation to Comment because it is not considered a "preferable" method of accounting.

[3] Refer to "Accounting's White Knight," *Fortune*, September 20, 2002.

- The fair value of stock-based compensation should be reduced to account for the possibility of forfeiture; however compensation cost previously recognized for awards that are subsequently forfeited should *not* be reversed

- All tax benefits associated with stock-based compensation should flow through the income statement, even tax deductions in excess of reported compensation cost

- There should be no exemptions to the fair value provisions for ESOPs, ESPPs, nonpublic companies, or companies accounting for stock compensation under Opinion 25

- Transactions with nonemployees should be accounted for in the same manner as transactions with employees if the fair value of the stock-based compensation granted is more readily determinable than the fair value of the goods or service received

Parties interested in commenting on the 25+ questions identified in the IASB's Exposure Draft should submit written comments to the IASB by March 7, 2003.[4] The following discussion summarizes the most substantive differences between the IASB proposal and Statement 123.

Treatment of Forfeitures

General – Perhaps the most difficult concept in the IASB proposal to understand for U.S. practitioners is the treatment of award forfeitures. Under longstanding principles in both Opinion 25 and Statement 123, compensation cost is not recognized for awards that do not vest because the award recipient fails to fulfill a service or performance condition. This is not necessarily the same outcome under the IASB proposal because of a subtle difference in the measurement philosophies of each standard. The measurement focus of Statement 123 is on the fair value of the equity instruments actually "issued," whereas the measurement focus of the IASB proposal is on the fair value of the "goods or services received."

Statement 123 – Companies are not permitted under Statement 123 to reduce the fair value produced from an option-pricing model (or otherwise) to account for the possibility of forfeiture. Rather, Statement 123 prescribes a "modified grant-date" approach whereby compensation cost is not recognized (or reversed if previously recognized) for stock-based awards that 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.

IASB Proposal – The grant-date fair value of stock-based compensation should take into account the possibility of forfeiture (regardless of the type of service or performance vesting condition), by either making adjustments to the option-pricing model or adjusting the model's output.[5] Compensation cost based on the reduced fair value is recognized as the services are received (discussed in the next section) and is *not* reversed if the award is later forfeited (it is treated as a

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[4] The FASB reminds its constituents that responding to the Invitation to Comment is not a substitute for commenting on the IASB Exposure Draft, as the FASB itself will not be directly commenting on the proposal.

[5] The IASB's Exposure Draft Implementation Guidance states that "… option pricing models can be adapted to take into account some types of market-based performance conditions, such as a target stock price that must be achieved for the options to vest. Similarly, the entity might incorporate into an option pricing model actuarial assumptions about employee turnover. In other cases, a more simplistic approach might be applied. For example, an entity might estimate the weighted average probability of forfeiture at grant date, and reduce accordingly the valuation produced by an option pricing model."

contribution to capital). However, any remaining measured but unrecognized compensation cost is not required to be recognized.

Attribution of Compensation Cost

General – An equally difficult concept to understand in the IASB proposal is how measured compensation cost is recognized over the service period. Under Statement 123, compensation cost for service-based awards is recognized either ratably over the vesting period in the case of "cliff-vesting" awards, or on an "accelerated accrual" basis in the case of graded-vesting awards.[6] Compensation cost for performance-vesting awards is recognized over the performance period based on the company's best estimate of the outcome of the performance condition, with adjustments in later periods to the extent actual experience differs from prior estimates.

Units-of-Service Method – The IASB proposal introduces a completely different methodology for recognizing measured compensation cost, referred to as the "units-of-service" method. A unit of service is an estimated amount of future services expected to be received, expressed in terms of a particular length of time (such as years, quarters, or months). In estimating future services, companies are to take into consideration service-vesting conditions but *not* performance-vesting conditions (whereas in the determination of fair value, both service-vesting and performance-vesting conditions are taken into account).

Fair Value Per Unit-of-Service – Once the number of units-of-service is estimated, companies are to divide the aggregate fair value of the stock-based awards granted (reduced for the possibility of forfeiture) by the total units-of-service expected to be received to obtain a "deemed fair value per unit-of-service." The deemed fair value per unit-of-service is then multiplied by the actual units-of-service received during a reporting period to calculate the amount of stock-based compensation cost to recognize for the period.

For Example – Assume a company grants to 10 employees an option on 500 shares of stock that is conditioned on continued service and the attainment of a financial goal after 1 year.[7] The company estimates the grant-date fair value of each stock option to be $10.00 before adjusting for the possibility of forfeiture due to the service-vesting and performance-vesting conditions. On the basis of a weighted average probability, the company estimates that 60 percent of the stock options will satisfy the service-vesting condition and there is a 50 percent chance of attaining the performance-vesting condition. Compensation cost is calculated as follows:

1. Total fair value of stock options granted

    10 employees x 500 stock options x $10.00 fair value per share x 60 percent probability of service vesting x 50 percent probability of performance vesting = $15,000 fair value

[6] The accelerated accrual methodology is prescribed in FASB Interpretation No. 28 (Interpretation 28), and is *required* if the expected life of the stock option is determined separately for each vesting tranche of the award.

[7] We acknowledge that stock-based compensation customarily vests or is earned over periods in excess of 1 year. The example is simplified, however, to illustrate the mechanics of using the units-of-service attribution method, not the technical intricacies of attributing stock-based compensation cost over multiple time periods. Both the FASB's Invitation to Comment and the IASB's Exposure Draft provide several examples illustrating the complexity of attributing stock-based compensation cost over multiple time periods.

2. Total units-of-service expected to be received (estimating that forfeitures occur midway through the year)

1 year of service x 6 employees	=	6
.5 years of service x 4 employees	=	2
Total units-of-service (in years)	=	8

3. Deemed fair value of each unit-of-service expected to be received

   $15,000 fair value of stock options granted ÷ 8 units of service expected to be received = $1,875 deemed fair value per unit of service

4. Compensation cost is calculated as follows assuming the following actual units-of-service received

	Scenario		
	More Employees Leave Than Originally Estimated	Everything Turns Out Exactly as Expected	Fewer Employees Leave Than Originally Estimated
Actual units-of-service received	5	8	10
Deemed fair value per unit-of-service	$1,875	$1,875	$1,875
Total compensation cost recognized (pre-tax)	$9,375	$15,000	$18,750

The example above illustrates how the amount of compensation cost recognized under the IASB proposal differs depending on the units-of-service actually received. It is important to note that compensation cost calculated in step 4 is recognized regardless of the performance outcome. That is, the performance outcome is only taken into account in the determination of fair value, not in the determination of the estimated or actual units-of-service received.

Other Differences

Income Taxes – Under Opinion 25 and Statement 123, when a company receives a stock-based compensation deduction on its tax return that exceeds the amount of compensation cost recognized in its financial statements (as would be the case under Statement 123 if the stock option gain at exercise exceeds the fair value at grant), the company is not permitted to reduce its income tax expense (and thereby increase its after-tax income) by this amount. Rather, the excess tax deduction bypasses the income statement and is credited to additional paid-in capital on the balance sheet. The IASB proposal requires that all tax deductions (including excess tax deductions) related to stock-based compensation should be recognized in the income statement. This difference with Statement 123 is significant because it results in changes to the company's income tax accounts based on changes in the company's stock price, and could result in a

company recognizing *income* in excess of cumulative stock-based compensation cost (if the award's intrinsic value significantly exceeds reported compensation cost) or *additional tax expense* (if the award's intrinsic value is less than reported compensation cost).[8]

Exclusions From Scope – The IASB proposal applies to all stock-based compensation transactions in which a company acquires or receives goods or services, except for transactions within the scope of another IFRS (such as stock-based compensation granted in a business combination). There are no exemptions for employee stock ownership plans (ESOPs) accounted for under AICPA Statement of Position (SOP) 93-6 or nondiscriminatory employee stock purchase plans (ESPPs) with minimal purchase discounts and no "option" features, as currently exist under Statement 123.

Transactions With Nonemployees – Statement 123 and EITF Issue No. 96-18 prescribe a "modified vesting-date" approach for nonemployee stock-based transactions (when the fair value of the stock-based compensation issued is more readily measurable than the fair value of the goods or services received), whereby compensation cost is based on the award's fair value at *vesting date* (rather than grant date as required by Statement 123 for stock-based transactions with employees). The IASB proposal draws no distinction between employee and nonemployee stock-based transactions under these circumstances, and thus requires compensation cost for nonemployee transactions to be based on the award's fair value at *grant date* consistent with employee transactions.

Nonpublic Companies – Statement 123 allows nonpublic companies to calculate stock-based compensation cost using the "minimum value" method, which does *not* take into account expected stock price volatility. The IASB proposal requires nonpublic companies to calculate compensation cost at fair value similar to public companies, and suggests several methods for estimating volatility, including valuing shares based on net assets, earnings, and share prices of similar public companies.

Footnote Disclosures – In addition to the comprehensive disclosures required by Statement 123 (other than the pro forma disclosures required for companies accounting for stock-based compensation under Opinion 25), the IASB proposal requires the following additional information:

- For stock options granted during the period, an explanation of any differences between historic volatility and expected volatility used to determine fair value
- For stock options granted during the period, assumptions made with regard to vesting conditions and an explanation of how vesting conditions have been taken into account in measuring fair value
- For stock-based compensation that vested during the period (or would have vested had the vesting conditions been satisfied), a comparison of the percentage of awards that vested and the grant-date estimate of the percentage of awards that were expected to vest
- For stock options exercised during the period, a comparison of actual option life and the grant date estimate of expected option life

8 Refer to "For Some, Options Rule Might Raise Profits," *The New York Times*, December 6, 2002.

Other Provisions – The FASB's Invitation to Comments also summarizes several other "secondary differences" between the IASB proposal and Statement 123, including the following:

- Statement 123 permits companies to use a "low end of the range" estimate for expected volatility and expected option life, and a "high end of the range" estimate for expected dividends; the IASB proposal instructs companies to use the "average of the range" in the above instances, resulting in a higher fair value estimate than under Statement 123

- Statement 123 stipulates that a reload option grant be measured at its subsequent grant date, even though the Statement acknowledges that ideally the fair value of the initial option with a reload feature should be estimated at grant date; the IASB proposal requires all stock-based compensation to be valued at grant, even awards with complex features such as reload provisions (thus, subsequent reload grants would *not* result in additional compensation cost)

- Statement 123 requires that compensation cost for liabilities arising from stock-based awards such as cash SARs be based on "intrinsic value" until settlement; the IASB proposal requires compensation cost to be based on the award's fair value, resulting in higher interim compensation cost accruals until expiration of the award's expected life when the "time value" component of the award is zero

Transition Provisions

In October 2002, the FASB issued an Exposure Draft that would allow companies voluntarily adopting Statement 123 to choose among three transition alternatives; prospective application to new awards, prospective application for new and unvested awards, and retroactive restatement. The amended transition provisions would be effective for fiscal years ending after December 15, 2002. The IASB proposal requires that the standard be applied prospectively to equity-settled stock-based compensation granted after November 7, 2002, and not yet vested as of the effective date. The standard's proposed effective date is for periods beginning on or after January 1, 2004 (assuming a final IFRS is issued by then). Further, the IASB proposal requires that the standard be applied retrospectively to liabilities arising from stock-based compensation at the effective date, except liabilities that are vested at the effective date, which would be measured at their settlement value (for example, intrinsic value for an SAR) rather than fair value.

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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:

- 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