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FAS 123(R) Requires Acceleration of Equity Compensation Cost for Retirement-Eligible Employees

A peculiar provision in new FASB Statement 123(R) has come to our attention that, to our knowledge, has received no publicity.

> Specifically, if an employee who receives an equity award is retirement eligible, and the terms of the award are that any nonvested portion of the grant would accelerate or continue to vest at retirement, grant date compensation cost must immediately be recognized at grant, not accrued over the vesting period (refer to paragraphs A57 and A58 of FAS 123(R)).
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> We further believe that, for awards made to retirement-eligible individuals prior to the effective date of FAS 123(R), which carry forward nonvested amounts into accounting periods starting after June 15, 2005, the full nonvested amount would be expensed in the first reporting period, not spread forward. This cost can be material.
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> Companies that confirm the accuracy of this information on equity awards to retirement-eligible employees and its applicability to their situation will need to reassess their estimates of the effect of FAS 123(R) on their financial statements during and after the transition period. Further, they may reassess the vesting provisions for retirement-eligible individuals going forward. If the award is thought to be reward and recognition for current or past performance, then acceleration of compensation cost may be reasonable and appropriate. However, if the award is an incentive for future service and performance, then the company may conclude that upon retirement, only a pro rata portion of nonvested awards should be deemed earned by service. The rest would be deemed unearned and forfeited.
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> Stated simply, compensation professionals may need to bring to the attention of senior management and the compensation committee the accounting effect of liberal vesting on equity awards at retirement and decide whether to reaffirm or change the vesting conditions.

Because this is a complex area in FAS 123(R)'s guidance, we have summarized our understanding of the relevant rules below.

In General – FAS 123(R) 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, 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 (FAS 123(R) 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 conditions in event of death, disability, or termination without cause. 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 operations, either on an absolute basis or relative to other companies (including events such as 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, and trued up at vesting for the actual number of shares earned.

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, previously recognized compensation cost is not reversed if the employee satisfies the requisite service period, even if the market condition is never satisfied and the award is forfeited. Conversely, previously recognized compensation cost is reversed if the employee fails to satisfy the requisite service period, unless the market condition is satisfied prior to the award forfeiture.

Requisite Service Period – FAS 123(R) introduces the notion of "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

FAS 123(R) provides complex guidance for determining the requisite service period, which may be deciphered as follows:

- If an equity award includes no substantive service, performance, or market conditions, the entire amount of measured compensation cost is recognized at grant date, such as an award granted to a retirement-eligible employee that includes an explicit service period (for example, the award vests after 3 years of service) but provides for accelerated or continued vesting upon retirement

- Nonsubstantive explicit vesting provisions (or the acceleration of explicit vesting provisions) are ignored when estimating the requisite service period for deep "out-of-the-money" awards that are deemed to have a market condition derived service period

- If a vesting condition requires the performance of future services, the initial estimate of the requisite service period is presumed to be the vesting period (unless there is clear evidence to the contrary), and 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 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 and recognize remaining compensation cost prospectively 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 is usually the grant date, but in certain circumstances may precede or be subsequent to the grant date) over the requisite service period based on the number of awards that are expected to vest, with cumulative 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 either ratably or on a more complex accelerated accrual basis (as originally prescribed by FASB Interpretation No. 28) that assumes each vesting tranche is a separate award (a policy decision made by the company).

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."

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General questions about this letter may be addressed to Thomas M. Haines in our Chicago office at 312-332-0910 or by e-mail at tmhaines@fwcook.com. Copies of this letter and other related materials are available on our website at www.fwcook.com under the following links:

Date	Title	Website Link
December 20, 2004	FASB Issues Final Statement on Accounting for Share-Based Payment	http://www.fwcook.com/alert_letters/12-20-04%20FASB%20Issues%20Final%20Statement%20on%20Accounting%20for%20Sha..pdf

October 20, 2004	FASB Decides on Effective Date for Option Expensing	http://www.fwcook.com/alert_letters/10-20-04%20FASB%20Decides%20on%20Effective%20Date%20for%20Option%20Expensing.pdf
September 3, 2004	FASB Makes Progress on Stock Compensation Redeliberations	http://www.fwcook.com/alert_letters/9-3-04%20FASB%20Makes%20Progress%20On%20Stock%20Compensation%20Redeliber..pdf
July 22, 2004	Update on Close of FASB's Public Comment Period	http://www.fwcook.com/alert_letters/7-22-04-Update%20on%20Close%20of%20FASBs%20Public%20Comment%20Period.pdf
May 28, 2004	Lattice-Based Stock Option Valuation Models	http://www.fwcook.com/alert_letters/5-28-04%20Lattice-Based%20SO%20Valuation%20Models.pdf
April 13, 2004	FASB Issues Exposure Draft on Share-Based Payment	http://www.fwcook.com/alert_letters/4-13-04-FASB%20Issues%20Exposure%20Draft%20on%20Share-Based%20Payment.pdf.
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