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New York • Chicago • Los Angeles

June 22, 2001

New International Accounting Standards Board May Try to Impose an Earnings Charge for Stock Options Under U.S. GAAP

Two "leadership projects," accounting for employee stock options and business combinations, are at the top of the agenda for fast-track action by the newly formed International Accounting Standards Board ("IASB"). This agenda was endorsed by the heads of the accounting standards-setting bodies among so-called G-8 nations meeting together in London on May 24.[1] A final decision to proceed with the stock option project will be made in July. The intent would be for any new stock option accounting standard that evolves from this process to be adopted by all eight nations, including the U.S. If this happens, the new standard would replace APB Opinion No. 25, which has governed stock option accounting in the U.S. since 1972, and SFAS No. 123, which was adopted by FASB in 1995 as an alternative to Opinion 25.

The mission of the IASB is to produce common global accounting standards for important business transactions and to encourage their adoption by member nations. It was formed in January with the appointment of 14 members by a commission headed by Paul A. Volcker, former chairman of the Federal Reserve. The IASB is headed by Sir David Tweedie, former head of the UK's Accounting Standards Board, and includes two former U.S. FASB members, James J. Leisenring and Anthony T. Cope.

Uniform standards for financial reporting are important to companies wishing to raise funds and list their securities in different countries and to comply with regulatory filing requirements in a cost-effective manner. They also prevent problems that would occur if one nation wanted to adopt stricter rules for certain transactions but was prevented from doing so by the concern that it would place that nation's businesses at a comparative disadvantage in global commerce. All nations would be encouraged to adopt the same global standards, thus preventing anyone from being disadvantaged.

The problem with the uniformity imperative when it comes to stock options is that a uniform global accounting standard already exists. No nation, to our knowledge, requires a "fair value" expense for fixed-term, at-the-money stock options granted to employees. All permit the same grant-date, intrinsic value method allowed by the FASB for U.S. GAAP. Thus, the argument for a new standard for stock options is not based on the principles of global uniformity, but rather the view that current accounting treatment is wrong. Many accounting professionals and others believe that stock options have a value; therefore, they must have a cost to the organization granting them. They believe that value may be estimated with reasonable accuracy by existing option pricing models. Not requiring a P&L expense for an option's value, they believe, distorts financial reporting by understating compensation expense and overstating operating profits.

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1 IASB member nations are Australia, Canada, France, Germany, New Zealand, the United Kingdom, the United States, and Japan

The probable outcome of the IASB's project on stock option accounting will be a proposal to require a P&L expense for stock options equal to their "fair value" on the date the option vests. The reason we believe "fair value"/vesting date accounting is the probable outcome of the IASB's work is that this was the proposal of the IASB's predecessor, the G4+1 Group. This group of representatives from the national accounting standard-setting bodies of Australia, Canada, New Zealand, the U.K. and the U.S. released a special report, "Accounting for Share-Based Payment," in July 2000 and asked for comments on the following summary proposals:[2]

- Granting stock options or shares to employees in exchange for services should be recognized in the financial statements,
- The value of options issued should be measured using an option pricing model,
- The value should be measured at the date the employee has performed the services necessary to earn the option, i.e., the vesting date, and
- Between the grant and vesting date, estimates of fair value should be accrued.

At the formation of the IASB, the G4+1 Group disbanded. Presumably, the IASB will pick up where G4+1 left off on the stock option accounting project.

The IASB will not be able to *impose* new accounting standards on member nations. But each nation's accounting standards-setting body likely will coordinate its activities with those of the IASB in the interests of achieving common global standards in important areas. The U.S. FASB's strategy will be to adopt a common agenda with the IASB for new projects, if possible. This means the FASB may soon find itself reopening the contentious subject of stock option accounting which is now essentially settled after a decade-long debate.

If the IASB proposes and the FASB adopts a new standard requiring stock options to be expensed at their "fair value" on the vesting date, the result would be a radical departure from present practices. On the one hand, by raising the costs of all equity incentives and requiring variable P&L expense between grant and vesting, it would reduce the willingness of companies to use equity incentives in their compensation programs, particularly at middle and lower levels. On the other hand, it would level the playing field between time-vesting and performance-vesting awards, leading to a new generation of shareholder-friendly design variations such as performance-vesting stock options and stock options with indexed exercise prices.

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This letter is intended to alert compensation professionals to a development that could affect their companies. General questions on the IASB stock option project may be addressed to Fred Cook at (212) 986-6330. This letter and other published materials are available at www.fwcook.com.

Source material for this paper included Financial Accounting Series No. 211-A, "Accounting for Share-Based Payment," July 2000; "Fewer Borders for Global Accounting," The New York Times, January 23, 2001; G4+1 Communiqué, January 2001, on FASB website; "Tax Budget & Accounting," Daily Tax Report, April 23 and May 25, 2001; and FASB Financial Accounting Series Status Report, No. 220, May 29, 2001.

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2 See our comment letter dated November 6, 2000, on our website at www.fwcook.com in the "Opinion Pieces" section under "Publications"