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FASB Makes Headway on Stock Compensation Project

The Financial Accounting and Standards Board (FASB) has met three times since deciding to revisit the provisions of its statement of Financial Accounting Standards No. 123 (FAS 123), with tentative decisions made in a number of important areas. Concurrently, the International Accounting Standards Board (IASB) has been busy deliberating the comments received on its Exposure Draft 2 (ED 2), Share-based Payment. Importantly, the FASB and IASB are converging on various items critical to the stock-based compensation issue. This letter is intended to brief readers on the latest developments in accounting for stock-based compensation.

> Key developments in the stock compensation project include: (1) the FASB decided that employee stock-based compensation should be recognized as an expense in financial statements, based on "fair value" measurement, and using a "modified grant date" and cost attribution approach as outlined in FAS 123, i.e., no Opinion 25 exception, (2) the IASB adopted the FAS 123 modified grant date and cost attribution methodologies, (3) the FASB formed an "Option Valuation Group" (OVG) to advise on several FAS 123 option valuation issues, and (4) the FASB agreed to explore the concept of "exchange date" measurement for nonemployee stock-based compensation.

Considering the complexity and controversy surrounding the stock compensation project, the progress the FASB has made so far is notable. Even so, the Board and Staff have a significant amount of work ahead of them. Recent developments include:

- At the April 22, 2003 meeting, the FASB decided that stock-based compensation should be recognized as an expense in financial statements, notwithstanding arguments to the contrary that footnote disclosure provides an adequate surrogate for recognition, or that recognition would result in a "double-dip" hit to earnings per share, and so forth. The FASB further decided that the measurement of this expense should be based on fair value.

- At the May 7, 2003 meeting, the FASB decided to use the modified grant date and cost attribution approach under FAS 123, rather than the pure grant date and "units-of-service" method proposed by the IASB in ED 2. The modified grant date approach is essentially the same as measuring compensation cost on the grant date, except that previously recognized compensation cost is reversed if stock-based awards are subsequently forfeited. In this way, the modified grant date approach allows "outcome-based knowledge" (i.e., actual forfeitures) to reduce or eliminate measurement error when estimating forfeitures in option pricing models. The cost attribution approach prescribed by FAS 123 means that compensation cost should be recognized, either on a pro rata or an accelerated basis, over the service period which is generally presumed to be the vesting period. Also during May, the IASB acquiesced to the FAS 123 modified grant date and cost attribution methodologies.

- Less than one week later, the FASB's OVG met with the Staff to discuss stock compensation valuation issues. While few conclusions were drawn from these discussions, some critical issues were brought to light, including: the limitations of current option valuation models; the best way to adjust the model to incorporate nontransferability, common employee behavior considerations, and other relevant factors; and appropriate valuation approaches for specialized situations such as reload options and non-public stock options. Many predict that when the dust settles, current option pricing models will prevail, with a wide range of adjustments permitted, i.e., a "principles-based" approach.

- On June 3, 2003, a hearing of the House Capital-Markets Subcommittee on the proposed "Broad-Based Stock Option Plan Transparency Act" (introduced March 20, 2003 as H.R. 1372 and S. 979) kept some hope alive for opponents to expensing stock options. This legislation would delay the implementation of the new accounting rules for stock-based compensation for three years, pending study by the SEC and the Commerce department. In the meantime, however, the SEC would mandate enhanced disclosure for equity compensation. FASB Chairman Robert Herz cautioned that congressional interference with FASB's independent standard setting establishes "a potentially dangerous precedent."

- In an apparent digression from more pressing issues, the FASB met on June 18 to discuss measurement issues related to stock-based compensation for *nonemployees*.

    - The Board acknowledged that this issue seemed to be a "detour" from the ostensibly higher priority of stock-based compensation for employees, but believed the debate was worthwhile in that it reaffirmed the FASB's decision to use the modified grant date approach for employees.

    - The Board agreed that employee and nonemployee stock-based compensation should be treated in a consistent manner, but decided to explore further the notion of using "exchange date," the date at which the company begins to receive goods or services from the nonemployee in exchange for the stock-based compensation. The exchange date method would be consistent with the modified grant date method for transactions with employees, because the employee begins to provide services to the company at grant date, and thus the exchange date and grant date are the same.

At the end of the last meeting, members of the Board indicated that the next hurdle would be agreeing upon the most appropriate valuation methodology for stock-based compensation. The work done by the OVG will likely be quite helpful to the FASB as they endeavor to build consensus around what is arguably the most complex and contentious aspect of this project.

A brief summary of the significant differences between FAS 123 and ED 2 and the FASB's tentative conclusions to date, is summarized at the end of this letter.

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General questions about this letter can be addressed to Thomas M. Haines or Cimi B. Silverberg in our Chicago office at 312-332-0190 or by email at tmhaines@fwcook.com or cbsilverberg@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 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

Differences Between FAS 123 and IASB ED 2 and
<u>Tentative FASB Conclusions to Date</u>

Issue	IASB ED 2 Methodology	FAS 123 Methodology	FASB Tentative Conclusion
Measurement Focus	Goods or services received	Equity instruments issued	FAS 123 approach *(May 7, 2003)*
Measurement Approach	Grant date	Modified grant date	FAS 123 approach *(May 7, 2003 reaffirmed June 18, 2003)*
Treatment of Forfeitures	Reduce grant date fair value (both service and performance conditions)	No reduction to fair value for estimated forfeitures	Not yet deliberated
Reversal of Forfeitures	No, previously accrued cost never reversed (but no additional cost recognized)	Yes, if not related to a stock price or intrinsic value condition (or expiration of an unexercised stock option)	FAS 123 approach *(May 7, 2003 reaffirmed June 18, 2003)*
Accrual of Cost	Units-of-service method (based solely on service conditions, not performance conditions)	Ratably or on accelerated basis over vesting period based on expected outcome	FAS 123 approach *(May 7, 2003 reaffirmed June 18, 2003)*
Treatment of Income Taxes	All tax effects flow through income statement	Excess tax benefits credited to equity on balance sheet	Not yet deliberated
Exclusions from Scope	No exceptions, unless within the scope of another standard, e.g., business combinations	Exceptions for ESOPs and ESPPs with minimal purchase discounts and no option features	Not yet deliberated
Transactions with Nonemployees	Treated the same as employees	Modified vesting date approach under EITF 96-18	Exploring "exchange date" approach; trying to treat employee and nonemployee transactions consistently *(June 18, 2003)*
Nonpublic Companies	Treated the same as public companies	Can use "minimum value" methodology (no volatility estimate)	Not yet deliberated
Black-Scholes Inputs	"Average-of-range" estimates	"Low-end or high-end of range" estimates	Not yet deliberated
Stock-based Awards Settled in Cash	Compensation cost based on fair value	Compensation cost based on intrinsic value	Not yet deliberated
Reload Stock Options	Valued as part of original grant, if possible	Each reload grant valued separately	Not yet deliberated