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Heads Up

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In This Issue:

Narrowing Your Options! Fair Value Accounting for Share-Based Payments

Introduction

After months of deliberations, FASB has issued for public comment its controversial exposure draft, *Share-Based Payment, an amendment of FASB Statements No, 123 and 95.* If adopted as a final standard, public companies will no longer have the alternative of accounting for many of their share-based payment awards (e.g., employee stock options) at intrinsic value without any related compensation expense.[1] Instead, the exposure draft requires public companies to record share-based payments at fair value and recognize this amount as compensation expense, typically as the awards vest.

Summary of Key Concepts

Here's a rundown of the proposal's key concepts. As is our custom, we provide greater detail in an appendix that includes an assortment of frequently asked questions along with our interpretive response.

Scope

The proposed standard represents the first phase of a multi-phase project by addressing accounting for compensation expenses associated with **share-based payment awards issued to employees**. In subsequent phases, the Board plans on addressing the accounting for share-based payment awards issued in connection with Employee Stock Ownership Plans (ESOP) and nonemployee transactions. Until then, existing guidance for ESOPs (SOP 93-6) and share-based payments to nonemployees (FASB Statement 123 and EITF Issue 96-18) continues to apply.

[1] Throughout this article the term expense is used in the context of costs associated with share-based payment awards. Participants should keep in mind that these costs also can be capitalized as part of the cost to produce or build assets, such as inventory.

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Effective Dates

The proposed standard would be effective for awards that are granted, modified or settled[2] in fiscal years beginning after:

- **December 15, 2004, for public companies** and for nonpublic companies (relatively few fit this category) that use the fair-value-based method (as opposed to the "minimum value" method) of accounting under the provisions of FASB Statement 123 for recognition or pro forma disclosure[3] purposes
- December 15, 2005, for all other nonpublic companies.

Effectively, calendar year-end companies would adopt the proposed standard on January 1, 2005 (public and in rare circumstances nonpublic companies), or on January 1, 2006 (all other nonpublic companies).

Transition

Public companies and nonpublic companies that previously adopted fair value accounting would use the *modified prospective method*, recording compensation expense (as the awards vest) for share-based payment awards granted, modified or settled after the effective date of the standard. In addition, these companies would record **compensation expense (as the awards continue to vest) for the unvested portion of previously granted awards that remain outstanding at the date of adoption**, basing the amount of expense on the fair value amounts previously calculated and included in their FASB Statement 123 pro forma disclosures.

All other nonpublic companies would use the *prospective method* for transition, recording compensation expense (as the awards vest) for share-based payment awards granted, modified or settled after the effective date of the standard without considering compensation expense for the unvested portion of previously granted awards.

Other transition provisions apply to awards that will be classified outside of equity as liabilities (i.e., cash-settled stock appreciation rights) that will be remeasured at fair value. See Question 6 in the Appendix.

Measurement

The proposed standard will require the use of fair value as the relevant measure for share-based payment awards. While the proposed standard does not require the use of any particular valuation model it does require, at a minimum, certain inputs that need to be incorporated in the determination of fair value. Those inputs include: (1) the exercise price of the award, (2) the expected term of the award, (3) the current price of the underlying share, (4) the expected volatility of the underlying share, (5) the expected dividends on the underlying share, and (6) the risk-free interest rate(s) for the expected term of the award.

Appendix B of the proposed standard does indicate that a lattice model (e.g., a binomial model) as opposed to a closed-form model (e.g., a Black-Scholes model) provides a better estimate of fair value. Why? The lattice model permits companies to incorporate varying inputs over the award's term (e.g., varying terms, volatility percentages or dividend rates). A closed-form model only allows for the use of a single award term, volatility percentage or dividend rate.

Nonpublic companies will no longer be permitted to use the minimum value method allowed under FASB Statement 123.[4] The proposed standard requires **nonpublic companies to make a one-time policy decision** to account for their share-based awards at either (1) their intrinsic value remeasured at each reporting date (akin to variable plan accounting under APB 25) or (2) their fair value at the date of grant. See Question 3 in the Appendix.

Under the proposed standard, any discount offered to employees in connection with employee share purchase plans (ESPP) is compensatory unless offered to all shareholders of that class of security. In other words, most ESPPs will be compensatory under the proposed standard as they offer either a discount to employees, provide for a look back feature,[5] or allow for both.

Income Tax Accounting

Under the proposed standard, companies record **excess tax benefits on share-based awards as an increase to**

[2] In the context of this discussion settled refers to an employer's repurchase of share-based awards in exchange for cash or other assets.
[3] This does not include nonpublic companies that adopted the pro forma disclosure requirements of FASB Statement 123 using the minimum value method.
[4] The minimum value method permits a zero volatility assumption, understating the true fair value of options.
[5] Paragraph 29 of FIN 44 states in part, "An example of a look-back option is a provision in an employee stock purchase plan that establishes the purchase price as an amount based on the lesser of the stock's market price at the grant date or its market price at the exercise (or purchase) date."

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shareholders' equity, bypassing the income statement. However, tax benefit shortfalls (typically arising when the ultimate tax deduction is less than the grant-date fair value used for book purposes) reduce net income. This is a significant change from the existing requirements of FASB Statement 123, which permits shortfalls in the tax benefit to bypass the income statement and directly reduce additional paid-in capital—at least to the extent there are credit balances due to excess tax benefits from prior stock and option awards accounted for under the same method of accounting (i.e., either APB 25 or FASB Statement 123).

Modified Awards

Under the proposed standard, modified awards are viewed as an exchange of the original award for a new award, presumably one with greater fair value. As a result, companies would record the incremental fair value of the modified award as compensation expense on the date of modification or over the remaining vesting period (for unvested awards). The incremental cost is the excess of the fair value of the modified award on the date of modification over the fair value of the original award immediately before the modification.

Recognition of Compensation Expense

The proposed standard requires recognition of compensation expense over the vesting (service) period. However, under FASB Statement 123 companies were allowed to estimate forfeitures either upfront or recognize them as they actually occurred. The proposed standard requires companies to estimate forfeitures on the date of grant and to adjust that estimate when information becomes available that suggests actual forfeitures will differ from previous estimates. Companies that revise their forfeiture estimates would record the effects of the revision as a cumulative effect of a change in accounting estimate in the period in which the revision occurs. Keep in mind that a corresponding adjustment to the deferred tax asset is required for any change in forfeiture estimates.

Disclosure

The proposed standard beefs up the already hefty disclosure requirements for share-based payment arrangements. More significant additions include: (1) a tabular reconciliation of nonvested awards, (2) compensation expenses related to nonvested awards not yet recognized, (3) cash used to settle share-based awards, (4) cash received in connection with share option exercises, and (5) employees affected and incremental costs of award modifications.

Comment Period and Final Thoughts

Over the years, FASB (and its predecessors) have battled with the accounting for share-based payments, especially employee stock options. As recently as 1994, FASB attempted but failed to require companies to record compensation expense related to the fair value of employee options—facing possible Congressional disapproval and widespread opposition from many of its constituents.

This time FASB finds the wind at its back. A respectable number of leading U.S. companies voluntarily have elected to expense stock options, shareholder resolutions at a number of other companies encourage their boards to make the switch and in February 2004, the International Accounting Standards Board issued its final standard, *Share-based Payment*, that requires companies to record compensation expense based on fair value.[6]

That said, FASB's proposal is certain to find dedicated opponents as well as proponents. To join the fray, copies of the Exposure Draft are available for free download on FASB's website, www.fasb.org. Comments are due June 30, 2004.

[6] Interested? Download the publication at www.iasplus.com.

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Appendix

Questions and Answers Related to the Exposure Draft on Share-Based Payment

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Questions and Answers Related to the Exposure Draft on Share-Based Payment

Note: While this appendix covers many of the significant concepts of the proposed standard on share-based awards, it is not intended to be a comprehensive discussion.

Scope

1. What type of awards will be covered under the proposed standard?

The proposed standard revises only the accounting for share-based payment awards issued to employees, such as employee stock options. In subsequent phases of the share-based payment project, FASB will address Employee Stock Ownership Plans and nonemployee transactions. Until then, the existing guidance for both ESOPs and nonemployee transactions continues to apply.

2. For those awards that are not covered under the proposed standard what guidance should companies follow?

Until the FASB addresses ESOPs and nonemployee transactions in a subsequent phase of the project, companies should continue to use the guidance in SOP 93-6 for ESOPs and FASB Statement 123 and EITF Issue 96-18 for nonemployee transactions.

3. Are nonpublic entities required to follow this proposed standard?

Yes. Nonpublic entities are included within the scope of the proposed standard. In contrast to public companies, nonpublic companies will be permitted accounting alternatives for their share-based payment awards—they can account for them at either (1) their intrinsic value remeasured at each reporting date (similar to variable plan accounting under APB 25) or (2) their fair value at the date of grant.

Example

Assume a nonpublic company issued an "at-the-money" share-based payment award on January 1, 2006, with an exercise price of $20 and a four-year cliff vesting requirement. On January 1, 2006, the company elects to account for their awards under the intrinsic value provisions of the proposed standard. In addition, assume on December 31, 2007, and 2008, the company's common stock is valued at $30 and $35 per share, respectively. In 2007 the company records $5 ($10 x 50% = $5) of compensation expense as the award is 50% vested and the total intrinsic value is $10 ($30 – $20 = $10). In 2008 the company records an additional $6.25 (($15 x 75%) – $5 = $6.25) of compensation expense as the award is now 75% vested and total intrinsic value is $15 ($35 – $20 = $15).

Effective Dates and Transition

4. What are the effective dates of the accounting provisions of the proposed standard?

The proposed standard would be effective for awards that are granted, modified or settled[7] in fiscal years beginning after:

- **December 15, 2004, for public companies** and for nonpublic companies (relatively few fit this category) that use the fair-value-based method (as opposed to the "minimum value" method) of accounting under the provisions of FASB Statement 123 for recognition or pro forma disclosure[8] purposes
- December 15, 2005, for all other nonpublic companies.

[7]In the context of this discussion settled refers to an employer's repurchase of share-based awards in exchange for cash or other assets.
[8]This does not include nonpublic companies that adopted the pro forma disclosure requirements of FASB Statement 123 using the minimum value method.

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Effectively, calendar year-end companies would adopt the proposed standard on January 1, 2005 (public and in rare circumstances, nonpublic companies), or on January 1, 2006 (all other nonpublic companies).

5. Will companies be allowed to present prior year expense amounts on a comparable basis in their financial statements after adopting the proposed standard?

No. The proposed standard does not allow companies to retroactively restate their prior period financial statements to account for their share-based awards under the provisions of this standard. The only method of transition allowed for public companies is the *modified prospective method*. That said, public companies could adopt the retroactive restatement provisions of FASB Statement 148 in their December 31, 2004 financial statements prior to the effective date of the proposed standard on January 1, 2005, in order to achieve comparability of their financial statements with respect to share-based awards.

6. Will companies have to record a cumulative effect of a change in accounting principle upon the adoption of the proposed standard?

It depends. On the date of initial adoption companies will not be required to record a cumulative effect of a change in accounting principle for equity awards that were previously recorded at intrinsic value under APB 25 and will now be recorded at fair value under the proposed standard (e.g., employee stock option plans). Public companies follow the *modified prospective method* for transition. Under that transition methodology public companies record compensation expense (as the awards vest) based on grant date fair value (1) for all awards granted, modified or settled after the date of initial adoption and (2) for the unvested portion of previously issued awards that remain outstanding as of the date of adoption. In neither situation is there a cumulative effect.

In other situations, a cumulative effect change in accounting principle is required. In rare circumstances, awards that were previously classified as equity under existing accounting standards that now will be classified as a liability under the proposed standard (i.e., stock options where the stock price is indexed to inflation), any compensation expense previously recognized in connection with that award should be recognized as a liability and a reduction of paid-in capital on the date of initial adoption. To the extent that fair value of the award on the date of adoption exceeds previously recognized compensation expense, that excess, net of related taxes, should be recognized in the income statement as a cumulative effect of a change in accounting principle.

For awards that were previously accounted for as liabilities at their intrinsic value under existing accounting standards (i.e., cash-settled stock appreciation rights), all public companies and nonpublic entities that elect to account for their awards at fair value,[9] will be required to record an adjustment for a cumulative effect of a change in accounting principle for the difference between the amount currently recorded as a liability (i.e., intrinsic value) and the fair value of the award on the date of initial adoption.

7. Will companies that previously adopted fair value accounting under the transition provisions of FASB Statement 148, be impacted by the transition provisions of the proposed standard?

Depending on the transition method selected under FASB Statement 148, prior adoption of fair value accounting may affect the comparability of compensation expense recorded in the financial statements. A company may experience a "ramp up" in compensation expense in their year-over-year financial statements, as they transition from zero compensation expense under APB 25, to compensation expense recorded on a prospective basis under the "prospective method" of FASB Statement 148, to compensation expense for the unvested portion of previously issued awards (in addition to any prospective compensation expense under the proposed standard). Below is an example of the interaction of the "prospective method" of FASB Statement 148 and the required "modified prospective method" of the proposed standard.

[9]See Question 12 for a further discussion of the election that nonpublic entities will be required to make under the proposed standard.

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Example

Assume a company issued an "at-the-money" share-based award in calendar year 2002 with a grant-date fair value of $20 and a four-year vesting requirement. In 2002, the company recorded no compensation expense because the company accounted for the award at intrinsic value under the provisions of APB 25. In 2003, the company adopts fair value accounting under the prospective transition provisions of FASB Statement 148. As a result, no compensation expense is recorded in either calendar year 2003 or 2004, as the award previously was issued and the company adopted the prospective transition provisions of FASB Statement 148. Upon adoption of the proposed standard, in 2005, the company records $5 of compensation expense for the unvested portion of the award under the modified prospective method required under the proposed standard.

Measurement

8. How do vesting provisions impact the accounting for awards issued to employees?

The total amount of compensation expense recognized for a share-based payment award should be based on the number of awards **expected** to vest. Under the proposed standard, a company must estimate the number of awards that are expected to be forfeited and adjust that estimate and corresponding compensation expense as appropriate. Compensation expense related to share-based awards should be recognized over the requisite service period, which normally will be the vesting period. The service period is defined as the time period from the service inception date until the award becomes vested and its exercisability no longer depends on continued employee service. As long as the award vests, companies should not reverse any of the previously recognized compensation expense.

Example

Assume a company issues 1,000 share options on January 1, 2005, with a three-year cliff vesting requirement. Grant-date fair value equals $15. The company expects actual forfeitures to average three percent per year over the three-year vesting period. On January 1, 2005, the company calculates the number of awards expected to vest as 913 (1,000 x .97 x .97 x .97 = 913).

In 2005, the company would record $4,565 ((913 x $15) x 33.33% = $4,565) of compensation expense based on the expected number of shares that are expected to vest (913), the grant-date fair value ($15), and the amount of service that has been provided (one of three years).

Alternatively, assume at December 31, 2006, based on employee termination rates over the preceding two years, the company revises its estimate of forfeitures from 97% to 92%. The revised number of options expected to vest is 779 (1,000 x .92 x .92 x .92 = 779). In 2006, the company would have to record compensation expense based on the revised estimate of forfeitures. In 2006, the company would record compensation expense of $3,225, computed as the difference between the revised cumulative compensation expense $7,790 ((779 x $15) x 66.66% = 7,790) less the amount of compensation expense previously recorded ($4,565).

9. How should companies estimate fair value of their share-based awards?

Share-based awards should be valued using a valuation technique that is designed to form the basis for an amount at which the instruments being valued would be exchanged. The most common valuation techniques currently used in practice are the Black-Scholes (closed-form) model and the binomial (lattice) model.

10. What are the similarities and differences between the main valuation models in use today?

Both the closed-form model (Black-Scholes) and the lattice model (binomial) require companies to use the same model inputs. The key difference is that the lattice model allows companies to assume variations to these inputs during the term

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of the award. For example, the lattice model permits companies to vary the expected term of the award depending on employees' exercise and post-vesting termination behavior. The lattice model also allows companies to vary the volatility of the underlying stock and the dividend yield as changes in these factors are expected to occur.

11. What factors must a company consider in estimating fair value of their share-based payment awards?

At a minimum and regardless of the valuation technique it uses, a company must incorporate the following items into its estimates of fair value of share-based awards: (1) exercise price of the award, (2) expected term of the award,[10] (3) current price of the underlying share, (4) expected volatility, (5) expected dividends on the underlying share, and (6) the risk-free interest rate(s).

12. Will nonpublic companies account for their share-based awards differently under the proposed standard than under existing standards?

It depends. Upon initial adoption of the proposed standard, nonpublic companies must make a policy election that will require them to record their share-based awards either at intrinsic value each reporting period or at fair value on the date of grant. Subsequent changes to this policy election are permitted only if the change is to a *preferable* method (fair value) under the requirements of APB 20.

Nonpublic companies that change to the fair-value based method, either voluntarily or because they become a public company, would be required to apply the provisions of the proposed standard on a prospective basis to any awards granted, modified, or settled after the date of change. Awards that remain outstanding as of the date of change would continue to be accounted for under the intrinsic value approach.

13. How will share-based payment awards recorded as liabilities be measured under the proposed standard?

Public companies should measure their liabilities at fair value each reporting period under the proposed standard rather than intrinsic value as required by FASB Statement 123. Nonpublic companies should measure their liability awards in the same manner (intrinsic value versus fair value) that they have chosen to measure their equity awards under the proposed standard (See Question 12).

Example

Assume a public company issued a cash-settled stock appreciation right on January 1, 2005, with a fair value on the date of grant of $20 and a four-year cliff vesting requirement. On December 31, 2005 and 2006, the award has a fair value of $30 and $25, respectively. Based on the requirements of the proposed standard the company would record the liability award at fair value. On December 31, 2005, the company records $7.50 ($30 x 25% vested = $7.50) of compensation expense with a corresponding recognition of a share-based liability. On December 31, 2006, the company is required to remeasure the award at fair value on the reporting date. As a result, the company records an additional $5 (($25 x 50% vested) - $7.50 = $5) of compensation expense with a corresponding increase to the share-based liability.

14. Does the proposed standard change the accounting for Employee Share Purchase Plans?

Yes. Under the requirements of the proposed standard any employee share purchase plan that offers more favorable terms to its employees and does not offer those same terms to all other shareholders of that same class of shares would be considered compensatory. For example, most employee share purchase plans allow for either a discount or a look-back feature[11] that is offered only to employees. If either one of these conditions exist, that plan would be considered compensatory under the proposed standard.

[10] Expected term should consider both the contractual term of the award as well as employees' expected exercise and post-termination behaviors.
[11] Paragraph 29 of FIN 44 states in part, "An example of a look-back option is a provision in an employee stock purchase plan that establishes the purchase price as an amount based on the lesser of the stock's market price at the grant date or its market price at the exercise (or purchase) date."

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15. As further discussed in Question 16, *Market, Performance and Service* conditions affect the accounting for share-based awards. How are these terms defined?

Condition	Definition [12]	Example
Market	A condition affecting the exercise price, exercisability, or other pertinent factors used in determining the fair value of an award under a share-based payment arrangement that relates to the achievement of (a) a specified price of the issuer's shares or a specified amount of intrinsic value indexed solely to the issuer's shares or (b) a specified price of the issuer's shares in terms of a similar [footnote omitted] (or index of similar) equity security (securities).	Company A issues awards that become exercisable if its stock price increases from $10 to $15 per share.
Performance	A condition affecting the vesting (or exercisablilty), exercise price, or other pertinent factors used in determining the fair value of an award that relates to both (a) an employee's rendering service for a specified (either explicitly or implicitly) period of time and (b) achieving a specified performance target that is defined solely by reference to the employer's own operations (or activities).	Company A issues awards that vest in three years if the Company's earnings per share exceeds $1.00 per share in each of those three years.
Service	A condition affecting the vesting (or exercisablilty), exercise price, or other pertinent factors used in determining the fair value of an award that depends solely on an employee rendering service to the employer for the requisite service period. A condition that results in the acceleration of vesting in the event of an employee's death, disability, or termination without cause is a service condition.	Company A issues awards that vest annually over a four-year period.

16. How would the accounting differ under the proposed standard if a share-based award included a market, performance or service condition?

No compensation expense should be recognized for awards that are forfeited because a service or performance condition has not been attained. In contrast, compensation expense should be recognized for awards that contain a market condition if the employee remains in service for the requisite period of time regardless of whether the market condition is ever attained.

17. Can a company reverse compensation expense if a stock option expires unexercised?

No. Under the proposed standard previously recognized compensation expense should not be reversed for a vested award that expires unexercised.

[12] These definitions have been extracted from Appendix E of the proposed standard.

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Disclosure

18. What additional financial statement footnote disclosures does the proposed standard require?

Under the proposed standard, companies must provide significantly more financial statement footnote disclosures compared to current GAAP requirements. The more significant additions include: (1) a tabular reconciliation of nonvested awards, (2) compensation expense related to nonvested awards not yet recognized, (3) cash used to settle share-based awards, (4) cash received in connection with share option exercises, and (5) employees affected and incremental costs of award modifications.

The following provides a detailed comparison of the disclosure requirements under the existing standards and those that would be required under the proposed standard. Changes have been highlighted in bold text.

Existing Disclosure Requirements	Disclosures Under the Proposed Standard
1. Provide a description of the plan(s), including the general terms of the awards under the plans(s)	1. Provide a description of the plan(s), nonpublic companies must disclose method of measuring its share-based payment arrangements
2. For **each** year an income statement is presented provide the number and weighted average exercise price for the following groups of options: a. Outstanding at the beginning of the year b. Outstanding at the end of the year c. Exercisable at the end of the year d. Granted e. Exercised f. Forfeited g. Expired	2. For the **most recent** income statement presented provide the number and weighted average exercise price for the following groups of options: a. Outstanding at the beginning of the year b. Outstanding at the end of the year c. Exercisable or convertible at the end of the year d. Granted e. Exercised and converted f. Forfeited g. Expired
3. Not Required	**3. For the most recent income statement presented provide the number and weighted average exercise price for those instruments not included in Item 2 above (i.e., nonvested shares):** **a. Nonvested at the beginning of the year** **b. Nonvested at the end of the year** **c. Granted** **d. Vested** **e. Forfeited**
4. For each year an income statement is presented, provide: a. Weighted average grant-date fair value of options issued during the year b. The number and weighted average grant-date fair value of other equity instruments (i.e., nonvested stock) issued during the year	4. For each year an income statement is presented, provide: a. Weighted average grant-date fair value (**intrinsic value for nonpublic companies**) of equity awards issued during the year **b. Total intrinsic value of options exercised (or share units converted) and share units vested during the year**

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<table>
<tr><th>Existing Disclosure Requirements</th><th>Disclosures Under the Proposed Standard</th></tr>
<tr><td>5. Not Required</td><td>5. For options expected to vest as of the date of the latest statement of financial position provide the following information for awards outstanding:
a. Number
b. Weighted-average exercise price (or conversion ratio)
c. Aggregate intrinsic value
d. Weighted-average remaining contractual term</td></tr>
<tr><td>6. For each year an income statement is presented, provide:
a. A description of the method and the significant assumptions used to estimate fair value, including:
i. Risk-free interest rate
ii. Expected life
iii. Expected volatility
iv. Expected dividends</td><td>6. For each year an income statement is presented, provide (nonpublic entities that elect intrinsic value method are not required to disclose the following information):
a. A description of the method and the significant assumptions used to estimate fair value, including:
i. Risk-free interest rate
ii. Expected term, including method used to incorporate contractual life and expected exercise and termination behaviors
iii. Expected volatility
iv. Expected dividends
v. Discount for post-vesting restrictions and the method for estimating it</td></tr>
<tr><td>7. For each year an income statement is presented, provide:
a. Compensation cost recognized in income
b. The terms of significant modifications of outstanding awards</td><td>7. For each year an income statement is presented, provide:
a. Compensation cost recognized in income, including the income tax benefit (expense)
b. Compensation cost capitalized as part of the cost of an asset
c. A description of significant modifications, including the terms, number of employees affected, and total incremental compensation cost</td></tr>
<tr><td>8. Not Required</td><td>8. As of the latest balance sheet date presented, compensation cost related to nonvested awards not yet recognized and the weighted average period over which compensation is expected to be recognized</td></tr>
<tr><td>9. Not Required</td><td>9. The amount of cash received from exercise of share options and similar instruments granted under share-based arrangements, including the realized tax benefit recognized in equity</td></tr>
<tr><td>10. Not Required</td><td>10. The amount of cash used to settle equity instruments granted under share-based payment arrangements</td></tr>
<tr><td>11. Not Required</td><td>11. A description of the entity's policy, if any, for issuing shares-upon-share option exercise (or share unit conversion), including the source of those shares (i.e., new shares or treasury stock). If as a result of the policy the entity expects to repurchase shares in the following annual period, the entity shall disclose the expected amount of shares to be repurchased during that period.</td></tr>
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19. What are the disclosure requirements for companies that issue share-based payment awards under multiple arrangements?

For an entity that grants awards under multiple share-based payment arrangements, the company should provide the revised disclosure requirements separately to the extent that the differences in characteristics of each arrangement make separate disclosure important to the understanding of the company's use of share-based compensation. For example, it may be necessary to provide separate disclosure for those awards that are classified as liabilities versus equity, or awards whose exercise is dependent on market conditions.

20. Do companies still have to provide pro forma disclosures for share-based awards in prior periods?

Yes. In addition to the revised disclosure requirements identified in Question 18 above, for any period for which an income statement is presented that includes awards accounted for under the provisions of APB 25, public companies need to provide the pro forma information required by FASB Statement 123, as amended by FASB Statement 148. **Note:** Companies that adopt fair value accounting under the "retroactive restatement" provisions of FASB Statement 148 prior to the adoption of the proposed standard, would not be required to provide the pro forma disclosure.

Nonpublic companies that utilized the minimum value method for their pro forma disclosure requirements under FASB Statement 123, are not required to continue providing those disclosures under the proposed standard for any outstanding awards that are accounted for under the intrinsic value method of APB 25.

Modifications

21. How will modifications of share-based payment awards be accounted for under the proposed standard?

Under the proposed standard, companies will be required to record the incremental fair value of the share-based payment award as compensation expense on the date of modification or over the remaining vesting period (for unvested awards). The incremental cost would be computed as the difference between the fair value of the modified award on the date of modification over the fair value of the original award immediately before the modification.

22. How would re-pricings of share-based awards be accounted for under the proposed standard?

Under the proposed standard, re-pricings would be accounted for in a manner similar to a modification of an award. See Question 21.

23. How would a share-based award that was converted from a liability into equity and vice versa be accounted for under the proposed standard?

Assume an award previously has been classified as a liability. Because of a subsequent modification to the terms of the award (i.e., cash-settled stock appreciation right modified to a share-settled stock appreciation right) it should now be classified as an item of equity. According to the proposal, on the modification date companies should recognize amounts that were previously recorded as a liability as a component of equity (additional paid-in capital).

The amount of compensation expense attributable to the award should be the greater of the grant-date fair value, as if the award had always been classified as equity, or the fair value of the award on the date of modification. If the compensation expense of the modified equity award is less than the grant-date fair value of the original liability, (1) the liability is reclassified as additional paid-in capital, (2) the excess compensation expense (grant-date fair value of the liability award over the fair value of the modified equity award) that would have been recognized to date, based on the vesting conditions, is recorded as compensation expense with a corresponding entry to additional paid-in capital, (3) any unrecognized compensation expense is recognized over the requisite service period.

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Example

Assume a company issued a cash-settled stock appreciation right (SAR) on January 1, 2005, with a grant-date fair value of $30 and a four-year cliff vesting requirement. On January 1, 2007, the company modifies the award from a cash-settled SAR to a share-settled SAR. The fair values of the award on December 31, 2006, and on the date of modification are $25 and $20, respectively.

On December 31, 2006, the company marks the liability award to fair value ($12.50 ($25 x 50% vested = $12.50)) as required for liability awards under the proposed standard. On the date of modification, the company would record the award based on its grant-date fair value, as that is the higher of the awards grant-date fair value ($30) or modified fair value ($20). (1) The company would reclassify the $12.50 ($25 x 50% vested = $12.50) currently recorded as a share-based liability to additional paid-in capital. (2) The company would record $2.50, excluding the effects of income taxes, as incremental compensation expense with a corresponding increase to additional paid-in capital in the period of modification (($30 – $25) x 50% = $2.50). (3) The company would record the remaining $15 of compensation expense over the remaining service period.

For an award that previously was classified as equity and because of a modification of its terms, becomes a liability item, companies would recognize amounts that previously were recorded as a component of equity (additional paid-in capital) as a liability. On the date of modification, companies would recognize a liability for the portion of the award related to prior service, to the extent that the fair value of the modified award is equal to or less than the amount recognized in equity for the original award, with a corresponding reduction to additional paid-in capital.[13] In the event that the fair value of the modified liability award is in excess of the amount recognized in equity for the original award, the excess is recognized as compensation expense. **Note:** As the award is now classified as a liability it would need to be remeasured at its fair value each reporting period. See Question 12.

Example

Assume a company issued a share-settled stock appreciation right (SAR) on January 1, 2005, with a grant-date fair value of $30 and a four-year cliff vesting requirement. On January 1, 2007, the company modifies the award from a share-settled SAR to a cash-settled SAR. The fair value of the award on December 31, 2006, is $40.

As the modified fair value is greater than the grant-date fair value the company would: (1) reclassify the amount currently residing in additional paid-in capital $15 ($30 x 50% vested = $15) as a share-based liability, (2) the excess $5 (($40 – $30) x 50% vested = $5) would be recorded as incremental compensation expense with a corresponding adjustment to share-based liability in the period of modification, and (3) the share-based liability award should be recorded at fair value each reporting period with a minimum of $30 of compensation expense.

Alternatively, assume the fair value on the date of modification is $25 the company would: (1) reclassify the portion of the award's modified fair value $12.50 ($25 x 50% vested) that would have been recognized as compensation expense as a share-based liability and (2) the share-based liability award should be recorded at fair value each reporting period with a minimum of $30 of compensation expense. This is in keeping with the requirements that the compensation expense should be recorded, at a minimum, at the amount equal to the grant-date fair value.

24. How would the cash settlement of a share-based award be accounted for under the proposed standard?

Instead of modifying the terms of an award, assume a company offers to cash settle a share-based award that is already vested. First, the company must calculate the fair value of the award on the date of settlement. Once fair value is

[13] This could result in an amount remaining in additional paid-in capital.

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determined, the company would recognize the settlement as a repurchase of an outstanding equity instrument with no additional compensation expense recognized unless the company settles the award for an amount in excess of fair value. Any previously recognized compensation expense for the award remains unadjusted.

In contrast, if the awards are unvested at the time of settlement, cash settling the awards based on their fair value on the date of settlement effectively would vest the awards. As such, the company would recognize the settlement as a repurchase of an outstanding equity instrument, and any unrecognized compensation expense based on grant-date fair value immediately would be recognized in the period of settlement.

Other

25. How will the proposed standard change the recognition of income taxes for share-based payment awards?

Under the proposed standard, companies record excess tax benefits on share-based awards as an increase to shareholders' equity, bypassing the income statement. However, tax benefit shortfalls (typically arising when the tax deduction is less than the grant-date fair value) reduce net income. This is a significant change from the existing requirements of FASB Statement 123, which permits shortfalls in the tax benefit to bypass the income statement and directly reduce additional paid-in capital—at least to the extent there are credit balances due to excess tax benefits from prior stock and option awards accounted for under the same method of accounting (i.e., either APB 25 or FASB Statement 123).

Example

Assume a company grants non-qualified stock options to its employees with a grant-date fair value of $1 million and a four-year cliff vesting requirement. As the $1 million of compensation expense is amortized over the vesting period, the company will record a deferred tax asset equal to the book compensation expense multiplied by the corporation's combined statutory tax rate. Why? The company is recording compensation expense for financial statement purposes that does not yet represent a current deductible item for tax purposes.

If the tax deduction[14] on exercise is greater than the $1 million of compensation expense, the deferred tax asset will be reversed in full and the excess benefit will be credited to equity. If the tax deduction is less than the $1 million of compensation expense, the deferred tax asset likewise will be reversed, with the shortfall (i.e., the deferred tax asset in excess of the tax benefit) recorded as an increase to tax expense.

26. How will the proposed standard change the presentation of the statement of cash flows?

Under the proposed standard, companies are required to separately identify as operating cash outflows amounts that would have been paid for income taxes if it were not for the excess tax benefit on share-based awards as a result of increases in the company's share price beyond the award's exercise price. Companies would have to report an offsetting amount in cash inflows from financing activities for the cash retained for these excess tax benefits.

Example

Assume on January 1, 2005, a company issues a share-based payment award with a fair value of $1 million. Over the course of the requisite service period the company records the $1 million as compensation expense for accounting purposes. On December 31, 2008, the holder of the award exercises their option, and as a result, the company records a $1.75 million tax deduction on its 2008 tax return. The $.75 million difference between compensation expense recorded for book purposes ($1 million) and the tax deduction ($1.75 million) recorded for tax purposes would be shown as both (1) an operating cash outflow and (2) a corresponding cash inflow from financing activities on the company's 2008 statement of cash flows.

[14]The tax deduction is computed as the difference between the company's share price on the date of exercise and the exercise price stated in the award, multiplied by the number of options awarded.

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27. Will the proposed standard change the manner in which compensation expenses are attributed to share-based payment awards?

Yes. Under FASB Statement 123, companies had the option of either recording their estimated forfeitures up front (adjusting these original estimates if actual forfeitures were expected to differ from previous estimates) or recording the forfeitures in the period in which they actually occurred. In contrast to FASB Statement 123, the proposed standard requires companies to estimate its forfeitures on the date of grant and to adjust that estimate when information becomes available that suggests actual forfeitures will differ from those previous estimates. Companies who revise their forfeiture estimates would account for such revisions as a change in accounting estimate in the period in which the change occurs. When companies revise their forfeiture estimates, a corresponding adjustment to the deferred tax asset would be required for any such change in forfeiture estimates.

The proposed standard allows for reversals of book compensation expense only when employees forfeit unvested shares (consistent with the current guidance under FASB Statement 123) and even then, only if the forfeiture provision is not based on a condition related to market performance, such as the price of the issuer's stock or total shareholder return compared to an index. In the case of a forfeiture where book compensation charges are being reversed, the deferred tax asset similarly will be reversed against the related tax entry, without impacting the company's effective tax rate.

In addition, under FASB Statement 123, companies had the ability of attributing compensation expenses to awards with graded vesting ratably over the vesting period, or as separate awards with individual vesting periods. Under the proposed standard, companies must account for awards with graded vesting as separate awards that vest at different times.

Example

Assume a company grants 1,000 employee stock options each with a fair market value of $10. The options vest pro rata over the service period (one-fourth each year). Previously, the provisions of FASB Statement 123 would have permitted companies the option of recording compensation expense ratably (also referred to as the single award approach - **Method 1**) or graded (also referred to as the multiple award approach - **Method 2**) over the service period. Under the proposed standard companies are no longer permitted that election, they would have to record compensation expense based on a graded vesting approach.

Method 1

Company records $2,500 of compensation expense per year calculated as the fair market value of the award ($10,000) divided by the number of years (four) in which the award vests.

Method 2

Company records compensation expense of $5,208 in 2005, $2,708 in 2006, $1,459 in 2007, and $625 in 2008 calculated as follows:

Award	**2005**	**2006**	**2007**	**2008**
Tranche 1	2,500	-	-	-
Tranche 2	1,250	1,250	-	-
Tranche 3	833	833	834	-
Tranche 4	625	625	625	625
	5,208	2,708	1,459	625

28. How will the proposed standard interact with the provisions of FASB Statement 150?

The proposed statement will amend the guidance previously included in FASB Statement 123, such that, an instrument that is considered a liability instrument under the provisions of FASB Statement 150 will also be considered a liability instrument under the provisions of the proposed standard.

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