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This *Financial Reporting* letter was prepared and distributed by BDO Seidman, LLP to help our clients anticipate and respond to questions that may arise in connection with the implementation of FASB Statement No. 123 (Revised 2004), *Share-Based Payment*.

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Introduction

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued its long awaited (for some, long-dreaded) requirement to record compensation expense for employee stock options in the form of FASB Statement No. 123 (revised 2004) (Statement 123(R)), *Share-Based Payment*. Most public companies will apply the new accounting in fiscal years beginning after June 15, 2005. Small public companies (S-B filers) and private companies will apply the new accounting in fiscal years beginning after December 15, 2005. The new requirements apply solely to financial statements prepared in accordance with generally accepted accounting principles; the Federal income tax treatment of employee stock options is unaffected.

Key Provisions of Statement 123(R):

- Statement 123(R) was issued December 2004 and effective in fiscal years beginning after 6/15/2005 for public companies (other than S-B filers); fiscal years beginning after 12/15/2005 for S-B filers and private companies.
- Requires recognition of compensation expense based on fair value of award
- Narrows rules for noncompensatory plans.
- Requires liability classification for certain types of awards.

Background and Timeline

The vast majority of companies accounted for equity awards to employees in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Opinion 25 defines noncompensatory plans in substantially the same way as the Internal Revenue Code. As a result, broad-based employee stock purchase plans that are noncompensatory in accordance with Section 423 of the Code generally are also noncompensatory for financial statement purposes under Opinion 25. All other employee stock options are classified as compensatory under Opinion 25, but compensation is measured as the spread between the exercise price and the market price on date of grant, which usually is zero. As a result, under Opinion 25 no compensation expense is recorded for broad-based employee stock purchase plans or for most employee stock options.

In the early 1990s, the FASB proposed a new approach under which most broad-based employee stock purchase plans and all other employee stock options would be classified as compensatory, with compensation measured at fair value using an option-pricing model, like Black-Scholes-Merton. Under intense opposition, the FASB enacted a compromise (FASB Statement No. 123, *Accounting for Stock-Based Compensation*) under which companies were permitted to continue applying Opinion 25, with footnote disclosure of what earnings and earnings per share would have been under the new approach, or to apply the new approach. In recent years, about 800 companies, mainly larger public companies, have voluntarily adopted the new approach, but the majority of companies continue to follow Opinion 25.

Statement 123(R) requires companies to adopt the fair value approach. That is, it eliminates the choice of continuing to use Opinion 25 in the financial statements and disclosing the effects of the fair value method in the notes. However, rather than simply amending Statement 123 to eliminate the choice, the new standard makes a number of subtle changes to the approach introduced by the original Statement 123. In some cases these changes are improvements, for example, expanded guidance on the application of option pricing models and accounting for modifications. In other cases, these changes create additional complications (for example, the make-believe [derived] service period for awards with market conditions) or significant implementation issues (for example, the requirement that tax benefits for excess tax deductions may be recognized only when realized as a reduction of taxes payable).

Along with Statement 123(R), the FASB released a frequently asked questions (FAQ) document available at *www.fasb.org/project/123r_faq.pdf* in response to constituents' questions regarding the FASB's decisions included in the final standard. The FAQ explains the FASB's reasoning for issuing Statement 123(R) and summarizes the key issues discussed.

At the end of March 2005, the SEC staff followed suit and released Staff Accounting Bulletin No. 107 (SAB 107), providing guidance for implementing Statement 123(R). To summarize, SAB 107 covers the following:

- Overall support for the objectives and requirements of Statement 123(R)
- Choice of valuation models
- Assumption about expected volatility of stock price
- Assumption about expected term of employee options
- Analysis of prior credits to capital from excess tax benefits
- Interaction of Statement 123(R) with the SEC's redeemable equity rules
- Capitalization of compensation from share-based payment transactions in inventory or self-constructed assets
- Applicability of Statement 123(R) to options granted to nonemployees
- Acceleration of vesting before adopting Statement 123(R)
- Adoption of Statement 123(R) in the middle of a fiscal year
- Transition requirements for companies that become public companies after adopting Statement 123(R)
- Classification of compensation and non-GAAP financial measures

In addition, SAB 107 notes that the adoption of Statement 123(R), as well as changes to share-based payment arrangements that many companies are making, may affect the comparability of financial statements. Accordingly, SAB 107 encourages Management Discussion &Analysis (MD&A) disclosures to help readers understand how these changes affect the financial statements. We examine this point further in a subsequent section. For the complete text of SAB 107 refer to *www.sec.gov/interps/account/sab107.pdf* .

In April 2005 the SEC staff announced a delay in the effective date of Statement 123(R) for public companies to fiscal years beginning after June 15, 2005, rather than quarters beginning after June 15, 2005. For further information, refer to the SEC's press release at *www.sec.gov/news/press/2005-57.htm*

As companies began to wrestle with the requirements of Statement 123(R), the FASB formed a Resource Group comprised of preparers, auditors and consultants, along with

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observers from the SEC and PCAOB staffs, to provide additional guidance around some narrowly focused topics, a few of which we will address in this *Financial Reporting* letter. If the Resource Group reaches consensus on an issue, the Resource Group members are expected to communicate the consensus to their constituencies. The Resource Group members from Financial Executives International (FEI) have posted their minutes on the FEI website at *www.fei.org/news/finrep/fasb.cfm*. (The minutes for the three meetings are dated June, August, and October 2005.)

In response to implementation issues discussed by the Resource Group or raised by others, the FASB issued four FASB Staff Positions to amend specific provisions of Statement 123(R). All four Staff Positions are discussed in this letter.

Statement 123(R) is a lengthy document whose appendices represent an integral part in implementation of the standard. We have prepared this letter to advise our clients and friends of the key accounting issues and their potential implications. We have aimed to capture the major issues and conclusions encompassed by Statement 123(R) and provide you with practical implementation considerations.

What is the scope of Statement 123(R)? What plans does it cover?

Statement 123(R) covers plans for employees that convey shares of the employer's stock, derivatives (such as options) related to the employer's shares, or cash in amounts tied to the value of the employer's shares. Employee is defined the same as in FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation: an interpretation of APB Opinion No. 25*, as a person over whom the grantor exercises or has the right to exercise sufficient control to establish an employer-employee relationship. A grantee meets the definition of an employee if the grantor consistently represents that individual to be an employee under common law. In the U.S., this means that the grantee must be an employee for U.S. payroll tax purposes and an employee of the grantor under common law. In addition, certain leased employees qualify as employees, consistent with Interpretation 44. Finally, also consistent with Interpretation 44, awards to nonemployee members of the board of directors in their capacity as directors are covered in the scope.

Nonemployee awards

In general, the accounting for grants to nonemployees (including independent contractors, consultants and external service providers, as well as to employees of joint ventures and equity method investees) will continue to be governed by the consensus in Emerging Issues Task Force (EITF) Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services." The FASB potentially will deal with nonemployees, as well as Employee Stock Ownership Plans (ESOPs), in a subsequent phase of the share-based payment project. The consensus in EITF 96-18 differs in some respects from the accounting required in Statement 123(R), most notably the date on which compensation is measured. Consequently, Statement 123(R) contains complex guidance for measuring compensation when an individual changes status from employee to nonemployee, or vice versa. This will continue to be burdensome for employers whose employees frequently change status for accounting purposes, for example, employers who regularly transfer employees to and from corporate joint ventures.

EITF 96-18 states that share-based payment awards to nonemployees should be measured based on the fair value of the services received or the fair value of the award, whichever can be estimated more reliably. If the fair value of the award can be estimated more reliably, which is ordinarily the case for a registrant, then EITF 96-18 is the appropriate guidance and would take precedence over Statement 123(R)'s guidance about when to measure fair value. However, EITF 96-18 does not provide guidance on some classification and measurement issues. SAB 107 suggests that the guidance in Statement 123(R) should be followed if there is no conflicting guidance in the EITF consensus. Most significantly, and in a change from prior SEC guidance, if nonemployee options have limits on transferability or hedgeability like employee options do, it would be appropriate to use an estimated term rather than the full contractual term. Otherwise, the use of an expected term which is shorter than the contractual term would generally not be appropriate in estimating the fair value of the nonemployee options. Awards to individuals may have characteristics like employee awards, whereas awards to companies typically do not. See further discussion below regarding measurement and estimation of expected term of options.

Is the plan compensatory for financial accounting purposes?

Statement 123(R) defines noncompensatory plans far more narrowly than Opinion 25 and Section 423 the Internal Revenue Code. To be considered noncompensatory under

Statement 123(R), a plan must meet the following conditions:

- Substantially all employees who meet limited employment qualifications participate on an equitable basis;
- The plan has no significant option features; and
- The discount from market price does not exceed the issuance costs that would be incurred in a significant public offering, with a discount of 5% or less automatically considered to qualify ("safe harbor").

The vast majority of existing broad-based employee stock purchase plans do not meet the second and third conditions. Employee stock purchase plans often provide significant option features, and they typically provide a 15% discount from market price, which is in excess of the issuance costs of a public offering. If employers do not amend these plans, then they will be treated as compensatory under Statement 123(R), with compensation expense measured based on the guidance for option plans.

Most of the press commentary about Statement 123(R) has focused on executive stock options. For some companies, broad-based employee stock purchase plans may have a bigger accounting impact than executive stock options, and review of existing plans is warranted.

How Statement 123(R) differs from Opinion 25. The criteria for noncompensatory plans under Opinion 25 came from Section 423 of the Internal Revenue Code. As a result, plans that are noncompensatory for U.S. Federal income tax purposes generally qualify as noncompensatory under Opinion 25. As the income tax rules were interpreted over the years, some noncompensatory plans became quite lucrative for employees. For example, "look-back" plans under which employees pay 85% of the lesser of market price at the beginning or end of a 12-month period result in substantial gains to employees in periods of rising share prices.

How Statement 123(R) differs from Statement 123. Statement 123(R) maintains the more restrictive noncompensatory criteria of Statement 123.

Does the plan create equity interests or liabilities?

As noted in the next section, Statement 123(R) establishes different measurement dates for equity awards versus liability awards. Therefore, it is important for companies to properly identify the nature of their awards. Generally, plans that are settled by issuing shares to employees, including "cashless exercise" (net share settled) options, create equity interests, and plans that are settled by issuing cash to employees create liabilities. However, the model for distinguishing equity awards and liability awards under Statement 123(R) differs from the general guidance on liability versus equity classification in FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock." Generally, the guidance in Statement 123(R) identifies more awards as equity than would be the case under the general guidance.

Statement 123(R) provides that once an employee no longer gains any benefit in an award from being employed, the classification of the award as equity or liability should be determined under the general guidance rather than the specialized guidance of the Statement. Generally, an employee no longer gains any benefit from being employed after (1) an award is vested and (2) any early exercise provisions (for example, a requirement to exercise an option within 90 days of termination of employment) have lapsed. The result would have been that common features of employee awards classified as equity under Statement 123(R) would have caused the awards to be reclassified to liabilities upon vesting. This requirement caught many companies by surprise. In response, in August 2005, the FASB released FASB Staff Position (FSP) FAS 123(R) – 1, "*Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under* FAS 123(R)," which essentially eliminates the requirement to apply the general guidance to an award when an employee no longer obtains a benefit from continued employment. Said differently, if an award is granted to an employee, its classification as equity versus liability continues to be covered by Statement 123(R) until expiration or modification. The guidance in this FSP is to be applied upon initial adoption of Statement 123(R).

Statement 123(R) also indicates that an employee award that requires cash settlement under any circumstance, regardless of how remote, should be classified as a liability. Although not common, some awards contain such provisions, for example, upon a change in control. In February 2006, the FASB released FSP FAS 123(R) – 4, "*Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event*," which amends Statement 123(R) and requires a company issuing employee stock options to classify the options as liabilities only when it becomes probable that some

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event outside the employee's control would require cash settlement. If an equity award becomes a liability because a contingent cash settlement event becomes probable of occurring, the change in classification is accounted for similar to a modification from an equity award to a liability award under Statement 123(R). The guidance in this FSP is to be applied upon initial adoption of Statement 123(R). We discuss accounting for modifications in a subsequent section.

Temporary equity
The SEC's rules about temporary equity apply to share-based payment awards that are classified as equity under Statement 123(R). SEC registrants classify share-based payment awards that are puttable to the employer or contingently settled in cash as temporary equity.

Nonemployee awards
In SAB 107, the SEC staff indicates that the guidance in Statement 123(R) about whether an award is classified as a liability or as an equity instrument should be applied to nonemployee awards.

How Statement 123(R) differs from Opinion 25. Opinion 25 does not distinguish between equity and liability awards.

How Statement 123(R) differs from Statement 123. Statement 123 made a similar distinction between equity and liability awards. Most, but not all, awards are classified similarly under Statement 123(R) as under Statement 123.

If the plan is compensatory, when is compensation measured?

For plans classified as equity, compensation is measured at the grant date. This is true even if the plans have cashless exercise features or performance conditions that would have required "variable accounting" under Opinion 25.

For plans classified as liabilities, compensation is measured at grant date and then re-measured every reporting period until final settlement (akin to "variable accounting").

The definition of grant date in Statement 123(R) carries forward from Statement 123 the concept of "mutual understanding" by employer and employees of key terms and conditions. Under Statement 123, practice treated the grant date of an award as generally the date the award is approved in accordance with a company's corporate governance provisions, so long as the approved grant is communicated to employees within a relatively short time period from the date of approval. For many companies, the number and geographic dispersion of employees receiving share-based payment awards means that it is impossible to communicate with each employee immediately after the awards are approved by the board of directors (or management with the relevant authority).

Last summer, some accountants concluded that the term mutual understanding should be read literally and that the grant date would be the date that the terms were communicated to each individual employee. This would have been quite cumbersome for companies with many grants, because it would have resulted in multiple grant dates, with different fair values, for each group of awards. That conclusion caused consternation among employers and compensation consultants. In response, the FASB issued FSP FAS 123(R) – 2, "*Practical Accommodation to the Application of Grant Date as Defined in* FAS 123(R)" affirming prior practice under Statement 123. As such, the FSP clarifies that a mutual understanding of the key terms and conditions of an award to an employee should be presumed to exist at the approval date of the award if <u>both</u> of the following conditions are met:

1. The award is a unilateral grant (i.e., the employee may not negotiate terms and conditions with the employer), and
2. Key terms and conditions are expected to be communicated within a reasonable period from date of approval.

The guidance in this FSP is to be applied upon initial adoption of Statement 123(R).

How Statement 123(R) differs from Opinion 25. Under Opinion 25, compensation for some plans is measured at grant date and compensation for other plans is measured at a later date, typically either vesting date or exercise or settlement date, with compensation estimated at each reporting date. However, the dividing line in Opinion 25 relates to when the amount the employee must pay and the number of shares the employee is entitled to are known. If both factors are known at grant date, and vesting is not dependent on anything other than continued employment, compensation is measured at the grant date. Absent these conditions, compensation is measured at a later date when these factors become known, with interim estimates beginning at grant date. If the number of shares is not known solely because of uncertainty about whether the employee will render service for a stated period, the factors are known at grant date. If any other uncertainty exists about the number of shares, final measurement of compensation is delayed until that uncertainty is resolved.

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Situations involving delayed measurement often are referred to as "variable accounting," because the amount of compensation expense varies from period to period as the price of the company's shares changes.

How Statement 123(R) differs from Statement 123. Statement 123 is similar to Statement 123(R), in that compensation for equity interests is measured at grant date and compensation for liabilities is measured at exercise or settlement date with interim estimates.

If the plan is compensatory, how is compensation measured?

The fundamental principle in Statement 123(R) is that compensation is measured based on the fair value of the award. For shares, fair value is measured based on the quoted market price of the shares, or appraised fair value if the shares are not traded. For options, fair value is estimated using a recognized option-pricing model that at a minimum incorporates all of the following assumptions, which are reflective of contractual, market-based or estimated features:

- Current fair value of underlying shares
- Option exercise price
- Expected term of option
- Expected dividend yield over the expected term of the option
- Risk-free interest rate over the expected term of the option
- Expected volatility of the stock price over the expected term of the option

From a practical standpoint, companies should regularly review the assumptions used in estimating fair value for options. For those assumptions that are contractual (e.g., exercise price and maximum term) along with those that are market-based (e.g., underlying stock price and risk-free interest rate), an assessment should be done individually for each grant. For those assumptions that are estimated (e.g., expected term; expected volatility and dividend yield), assumptions should be updated annually unless there is a significant change in the company's business during the year (e.g., change in operations or in the workforce) that would warrant a re-assessment.

Note: The market price or appraised fair value of restricted stock at its grant date is not a forecast of what the market price or appraised value will be when restrictions lapse (vesting date). Market and company developments will affect the value of the shares over time. Similarly, the estimated fair value of an option at grant date is not a forecast of its intrinsic value at exercise date. Valuation techniques and models used for employee options and similar instruments estimate the fair value of those awards at a particular point in time. Assumptions used are based upon expectations and information available at the time the measurement is made. The fair value of an option is expected to change over time as a normal economic process. Therefore, subsequent outcomes that vary from the original assumptions do not call the original estimates into question.

Private company alternatives

To reduce compliance costs for private[2] companies, Statement 123(R) provides certain measurement alternatives. For stock options classified as equity awards, private companies that cannot practicably estimate the expected volatility of their own stock price, because transactions are too infrequent, are permitted to substitute the historical volatility of a relevant sector index. This method is known as "calculated value." While Statement 123(R) does not point to specific indices (of which there are many available) other than the Dow Jones Indices, it indicates that a company should select an index based upon companies that have operations that are most similar to its own operations. A broad-based index would be inappropriate, because the diversity associated with such an index would not be reflective of the specific industry sector(s) that the company operates in. The calculated value method should be applied using the daily historical closing values of the index over a period that equals the expected term of the option.

For liability awards, private companies may choose to measure compensation based on intrinsic (in-the-money) value rather than fair value or calculated value. Cumulatively, this will result in the same compensation expense, because fair value and calculated value converge on intrinsic value at settlement, but it avoids the costs of applying option-pricing models. However, fair value is the preferred method for justifying a voluntary change in a accounting principle under FASB Statement No. 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3*. In addition, the choice in measurement methods is a policy choice that should be applied consistently.

Inability to estimate fair value

In the *rare* instance that an equity instrument has such unusual terms that a company is not able to reasonably estimate fair value at grant date, Statement 123(R) requires application of the intrinsic value

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method. The instrument would be remeasured at each reporting date through exercise or settlement. **Note:** The company would continue to use the intrinsic value method even if it subsequently concludes that it has become possible to reasonably estimate fair value.

What option-pricing models are permitted?
Statement 123(R) describes two classes of option-pricing models: closed-form models (e.g., Black-Scholes-Merton) and lattice models (e.g., binomial). Under the final standard, either class of model is acceptable. Lattice models offer more flexibility to accommodate the unique features of employee stock options and, as a result, potentially offer more precise estimates of fair value. However, lattice models require more inputs than closed-form models, and many employers will not have the information readily available.

In its final standard, the FASB recognizes the challenges faced by companies and does not state a preference for a particular valuation technique or model to estimate fair value of options and similar awards. Rather, it highlights the advantages and disadvantages of current option-pricing models and how both the lattice and closed-form models may be adjusted to account for substantive characteristics of share options granted to employees. A company's selection process in determining an appropriate valuation technique or model should:

- consistently apply the fair value measurement objectives of Statement 123(R);
- be based on principles of financial economic theory generally applied in the field; and
- reflect all substantive characteristics of the instrument being measured.

A change in technique or model would be treated as a change in estimate rather than a change in accounting principle. Such a change in estimate should be applied prospectively to new awards. We discuss changes in estimates in more detail in a subsequent section.

So which option pricing model should companies use?
In our opinion, a closed-form model like Black-Scholes-Merton is a more cost effective choice for most companies. Lattice models require significantly more effort to develop assumptions. Some valuation specialists believe that the extra effort is worthwhile, because they believe that the estimated fair values generated by lattice models are more precise and tend to be lower that the estimated fair values generated by closed-form models. We have heard mixed reports about whether lattice models generate lower fair values and, if so, by how much. We believe that some of the greater precision of lattice models can be achieved in closed-form models by refining the assumptions about expected volatility and expected term, at less cost than applying lattice models. Further, because neither lattice models nor closed-form models take into account exercise behavior triggered by individual employees' personal financial situations, we question whether the purported greater precision of lattice models is as great as some proponents believe.

How Statement 123(R) *differs from Opinion* 25. Under Opinion 25, compensation is measured based on intrinsic value, that is, the difference between the amount the employee must pay and the fair value of the shares on the date compensation is measured. For share grants, intrin-

Comparison of lattice model with closed-form model

Closed-form models assume options are exercised at the end of the assumed term, and specific inputs such as volatility, expected dividends, and the risk-free interest rate are constant over the option's term. Therefore, the model may need to be adjusted to account for dynamic characteristics of the award (e.g., ability to exercise before the end of the contractual term) by using weighted-average assumptions of those characteristics.

Lattice models allow assumptions like expected dividend yield, risk-free interest rate, and expected volatility to vary over time. In addition, lattice models allow an employer to make explicit assumptions about the employees' likely exercise patterns, including "blackout periods." For example, an employer could assume, based on past experience, that employees will exercise half their options when the market price of the shares reaches 200% of the exercise price. As a result, the expected term of employee options is an output of a lattice model, rather than an input assumption. Applying a lattice model requires detailed information about the terms of options and of past employee behavior, divided into homogenous groupings, such as executives and rank-and-file employees. Many employers have never accumulated such detailed information about past employee behavior and, therefore, would be unable to apply a lattice model, at least initially. Small employers, even if they have the information, may not feel that the employee base is sufficiently large for the data to be predictive of future employee behavior.

sic value typically equals fair value. For options, however, fair value and intrinsic value may differ significantly at grant date. If the exercise price equals or exceeds the fair value of the shares at grant date, the intrinsic value is zero, but the option has fair value equal to its time value. Time value can be understood economically as the employee's benefit from the right to profit from appreciation of the shares without the burden of buying the shares and having an investment at risk.

How Statement 123(R) *differs from Statement* 123. Whereas Statement 123 permits an employer to choose between the intrinsic value model of Opinion 25 and the fair value model of Statement 123, Statement 123(R) eliminates that choice and requires use of the fair value model. Statement 123(R) also refines the fair value model as compared to Statement 123 as follows:

- Statement 123(R) provides more guidance on how to develop the assumptions needed to apply lattice models.
- Statement 123(R) provides more guidance on the most difficult assumption in option-pricing models—the expected volatility of the stock price. Estimating volatility is discussed in the next section.
- Liability awards are measured at intrinsic value under Statement 123. Under Statement 123(R), they are measured at fair value. Cumulatively the same compensation expense is recorded, because at exercise or settlement date fair value and intrinsic value are the same. However, for option-like liability awards, the interim estimates of compensation will differ.
- Finally, the alternative method for private companies is different. Under Statement 123, the alternative to fair value for private companies is to measure options using "minimum value" at grant date. Minimum value is computed by applying the Black-Scholes-Merton model with an expected stock price volatility of zero. Statement 123(R) requires fair value measurement but allows private companies that are unable to reasonably estimate fair value to use the "calculated value" method, as discussed above.

How is the expected volatility of the stock price estimated?

Estimating volatility – Key Points: Statement 123(R) states that entities should begin estimating expected volatility by considering historical volatility over a period generally commensurate with the expected or contractual term, as applicable, of the option. The SEC Staff, as stated in SAB 107, believes methods that place undue emphasis on the most recent periods may be inconsistent with this guidance.

Expected volatility represents a measure of the amount that the share price is expected to fluctuate during a period. (e.g., the higher the volatility, the more returns on shares can be expected to vary – up or down). When estimating expected volatility, a company needs to consider several factors including:

- Using historical volatility only as starting point and considering ways in which future volatility may differ from historical.
- Discounting historical volatility in periods attributable to non-routine transactions.[1] (e.g., taking into consideration volatility due to rare events not expected to occur again – such as a failed takeover bid).
- Using "implied volatility" based on the market value of traded options, that may indicate how future volatility would differ from historical volatility.
- For public companies, the length of time that shares have been publicly traded.
- For newly public or private companies, the expected volatility of similar entities[2].
- Intervals for price observations. (e.g., public companies would typically use daily price observations unless their stock is thinly traded; while private companies might use weekly or monthly observations).
- Corporate and capital structure. (e.g., highly leveraged companies would tend to have higher volatility).

Lattice models allow for an expected range of volatility over the option's expected term while closed-form models do not. This is obviously a matter of judgment to be applied by the company in determining which model to use and how best to incorporate expected volatility within the model chosen. Either

[1] Both SAB 107 and Statement 123(R) cite instances such as a failed takeover bid where it may be appropriate to adjust historical volatility for a discrete one-time non-recurring event. Generally, the event should be within control of the company and should exclude market-based events that are not within control of the company such as the "tech bubble" and the events of September 11, 2001. Such instances where a company excludes a certain period would be considered rare.

[2] Expected volatility may be based on a group of companies that are comparable to the entity. To find comparable public companies, consider a disclosure search on www.sec.gov within a particular Standard Industrial Classification (SIC). Factors to consider in judging comparability include industry, stage of life cycle, size and financial leverage. Industry sector indices should be avoided, since the effects of diversification that are inherent in the index make it less useful than the trading history of comparable individual companies.Closely-held companies should review the constituent companies included in indices and incorporate the same factors for comparability listed previously.

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way, the process for estimating expected volatility should be applied consistently.

How is the expected term of the options estimated?

Option valuation theory assumes that options usually will be held for their full contractual term, because early exercise sacrifices the remaining time value. A holder who wants to realize the value of an option is better off to sell the option and capture the remaining time value rather than to exercise it. Employee options, however, typically are non-transferable. In addition, in many cases option holders who terminate employment are required to exercise within 90 days of termination. Finally, employees typically have a significant portion of their net worth invested in or otherwise tied to their employer and, contrary to option valuation theory, diversifying that risk may not be possible and, if possible, may be costly. As a result of all of these factors, employees tend to exercise options before their full contractual term. Option valuation theorists refer to this as sub-optimal exercise behavior.

In both Statement 123 and Statement 123(R), the FASB concluded that traditional option valuation models should be modified to reflect the unique characteristics of employee options by substituting the expected term of the option for the full contractual term. The expected term of an option is the period of time during which the option is expected to be outstanding. Some factors to consider in estimating the expected term of options include:

- Employee exercise and termination behavior, which should divide and analyze employees based on homogenous groupings (e.g., hourly employees versus salaried). In SAB 107, the SEC staff comments that two employee groups are adequate for most employers.
- Reliability of data maintained by company versus data available from comparable sources (e.g., industry averages); and
- Impact of non-transferability of awards and effects of blackout periods.

Analyzing exercise and termination behavior based upon homogenous groupings of employees provides a better estimate than simply averaging the exercise behavior across all employees. A company also should review the reliability of data it maintains and consider utilizing comparable data, such as applicable industry averages. Another point is that the expected term of an option should never be shorter than the vesting period of the award. The assumption is that companies that allow exercise prior to vesting do so to obtain specific tax treatment and that shares must be returned if vesting conditions are not satisfied. We discuss vesting considerations further in a subsequent section.

As noted previously, under a lattice model the expected term of the option is an output. A company using a lattice model would enter specific assumptions about sub-optimal exercise behavior based on the terms of options and past employee practices. For example, if option grants require exercise within 90 days of termination of employment, a company would estimate the portion of employees who would terminate at various intervals after vesting, based on past experience. Similarly, an employer would examine past employee exercise behavior to see whether there are patterns of early exercise based on stock price movements. Anecdotal evidence suggests that employee exercises surge when the stock price reaches 200% of the strike price. Discerning such patterns of exercise involves significant data gathering, as well as subjective interpretations of the data. One factor that lattice models do not capture is the impact of personal financial situations on employee exercise behavior. Anecdotal evidence suggests that the timing of exercises may be linked to purchases of cars or vacation homes, significant home improvements, or a child entering college. No model captures such behavior, and to the extent that past employee behavior reflects such personal factors, it may not be predictive of future behavior of a different group.

The SEC staff recognized that for various reasons historical exercise activity of a company or other comparable companies may not be readily obtainable. Therefore, SAB 107 permits a "simplified" method for estimating expected term of a "plain vanilla option," which is computed as the arithmetic mean of weighted vesting period and contractual life.[3]

The simplified method is only allowed for options that contain all of the following characteristics:

- The share options are granted at the money;
- Exercisability is conditional only on performing service through the vesting date;
- If an employee terminates service prior to vesting, the employee would forfeit the share options;
- If an employee terminates service after vesting, the employee would have a limited time to exercise the share options (30-90 days); and
- The share options are nontransferable and nonhedgeable.

This simplified method may only be elected for those plain vanilla

[3] Refer SEC Staff Accounting Bulletin No. 107 – D.2 Question 6.

options issued prior to December 31, 2007, because the SEC staff believes that by then more detailed comparative information regarding expected term would be more widely available. In addition, the simplified method, if chosen, should be applied consistently to all plain vanilla options and disclosed accordingly. SAB 107 states that this method is not intended to be applied as a benchmark in evaluating the appropriateness of more refined estimates of expected term.

The simplified method also is appropriate for private companies.

Nonemployee awards

Note: In SAB 107, the SEC staff indicates that if nonemployee options have limits on transferability or hedgeability like employee options do, it would be appropriate to use an estimated term rather than the full contractual term. Otherwise, the use of an expected term that is shorter than the contractual term would generally not be appropriate in estimating the fair value of the nonemployee options.

How are restrictions on shares or options considered?

A key concept in Statement 123(R) is that restrictions on shares or options *prior* to vesting are ignored in estimating fair value, while restrictions on shares or options *after* vesting are contemplated in estimating fair value. Like Statement 123, Statement 123(R) is based on a modified grant date model in which zero compensation is recorded for options or shares that an employee forfeits through failure to meet service (employment) or performance (either individual or company performance targets) conditions. Accordingly, restrictions on shares or options during the period before vesting are ignored in estimating fair value, because it would be double counting to reduce the fair value for such restrictions and also to reverse compensation for forfeited awards. Restrictions after vesting, (e.g., a requirement for an employee to hold the shares for a specified period) would be considered in estimating fair value.

Practical note: For options that are fully vested at the grant date, the effects of nonhedgeability and nontransferability would be taken into account in estimating the fair value of the awards via the estimate of an employee's expected exercise and post-vesting employment termination behavior (see discussion of expected term above). Reload features (those that provide for automatic grants of additional options whenever an employee exercises previously granted options using shares rather than cash)[4] and clawback features (e.g., noncompete clause that requires transfer of earned awards back to the issuing entity upon violation)[5] should not be reflected in the grant-date fair value of an equity award. These would be accounted for if and when the reload grant or clawback occurs.

If the plan is compensatory, over what period is compensation recorded?

Period over which compensation is recorded – Key Points:

Key concepts in regard to the period over which compensation for equity awards is to be recorded include:

- Recognition of expense ratably over the requisite service period – awards with service conditions and graded vesting may be treated either as a single award or as separate awards
- Determination of requisite service period – can be explicit, implicit or make-believe (derived) and should consider all terms of the award
- Estimation of and true-up to actual for forfeitures of awards – No compensation recognized for forfeitures due to failure to achieve a service or performance condition. If an employee forfeits an award due to failure to achieve a market condition but the requisite service is rendered, compensation previously recognized is not reversed.

Requisite Service Period

Consistent with past requirements, compensation generally is accrued ratably over the period that the employee renders service in exchange for the award. In addition, for liability awards, compensation would continue to be adjusted for changes in value after vesting through settlement.

The period over which an employee renders service in exchange for the award is referred to in Statement 123(R) as the requisite service period. A requisite service period may be explicit, implicit or make-believe (derived), and requires careful analysis of the award's terms to determine what that period is. A stated employee service period is an explicit service period (e.g., an award that vests after two years of continuous service has an explicit two-year requisite service period). An award that provides for vesting of shares on successful completion of a proj-

[4] Refer to Appendix E and paragraph A5 of Statement 123(R) for the definition and accounting, respectively, for reload features.
[5] Refer to footnote 44 and paragraph A5 of Statement 123(R) for a discussion of clawback features.

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ect with an estimated completion date is an example of an implicit service period (e.g., an award that vests upon completion of a Stage II clinical trial that is expected to be completed in 24 months has an implicit two-year requisite service period). For awards that contain market conditions, Statement 123(R) requires an employer to estimate a make-believe service period representing an expected time interval until the market condition is satisfied (e.g., an award that is exercisable if the price of the stock doubles from its level at the grant date would require the use of a lattice model to estimate the average expected period of time for the stock price to double, and that period would be the make-believe [derived] service period for that award). For awards with market conditions, compensation is accrued over the make-believe service period rather than over any explicit service period in the award. For example, if options that are exercisable if the stock price doubles are fully vested at grant date, the explicit service period (zero) is ignored and compensation is accrued over the make-believe service period instead. The FASB's rationale is that some period of time is necessary for a market condition to be satisfied, and that an employee is effectively required to work for that period to earn the right to the award, regardless of any shorter explicit service period. The FASB's position has theoretical merit, but we question whether accruing the compensation over a different period was a sufficient reason to introduce the complications of the make-believe service period.

Estimation of the requisite service period and any subsequent adjustments to that estimate should be based on an analysis of each of the following:

- All vesting and exercisability conditions;
- All explicit, implicit and make-believe (derived) service periods; and
- Whether it is probable[6] that performance or service conditions will be satisfied.

For awards with service or performance conditions, a company estimates how many awards will vest and accrues compensation only for those awards. The probability of vesting is updated at each reporting period, and compensation is adjusted via a cumulative catch-up adjustment to reflect the latest estimate. Ultimately, compensation is trued up to reflect actual forfeitures, so that compensation is recorded for awards that vest and not recorded for awards that are forfeited.

If an employee forfeits an award because he fails to fulfill a service requirement or fails to achieve a performance condition, no compensation cost is recorded for the forfeited award. If compensation was accrued in earlier periods, it is reversed in the period of forfeiture. If an employee fulfills all of the conditions and vests in an award but does not exercise it, because the stock price falls making exercise uneconomic, compensation cost is not reversed. Also, if an employee forfeits an award because a market condition is not satisfied, compensation is not reversed. We discuss the impact and accounting for performance, service and market conditions more fully in the next section.

For awards with explicit service conditions and graded vesting, a company may treat each vesting date as a separate award and accrue compensation separately, or it may treat all of the vesting dates as a unit and accrue compensation over the period to the last vesting date. For example, if an employer grants 100 shares of restricted stock with a fair value of $10 per share at grant date, with 25% vesting on each of the first four anniversary dates, and chooses to account for each tranche separately, compensation for each tranche of 25 shares would be accrued as shown at the top of page 12.

Note: More than 50% of the aggregate $1,000 of compensation expense is accrued over the first 12 months.

Alternatively, the employer could treat the entire award as a unit and accrue the total compensation of $1,000 ratably over the four-year service period at $250 per year. Under this approach, compensation should accrue at least as fast as the award vests.

Retirement-eligible employees

Another practice issue that companies will need to consider involves the treatment of option or restricted stock grants to retirement-eligible employees that continue to "vest" after retirement. Statement 123(R) requires companies to accrue compensation expense over the period from grant date to the earliest retirement date. This represents a change from prior practice under which many companies accrued compensation over an expected service period. Companies that permit periods after retirement to count toward vesting will need to develop procedures to identify grants to retirement-eligible employees and accrue compensation over the period to the earliest retirement date rather than the expected service period.

[6] Per Footnote 25 of Statement 123(R) "probable" is used in the same sense as in FASB Statement No. 5, *Accounting for Contingencies*: "the future event or events are likely to occur" (paragraph 3).

Graded vesting example from page 11						
Anniversary for Vesting	**Shares Vesting**	**Compensation Expense**	**Year 1**	**Year 2**	**Year 3**	**Year 4**
First	25	$250	$250	$0	$0	$0
Second	25	250	125	125	0	0
Third	25	250	83	83	84	0
Fourth	25	250	62	63	62	63
Expense by year		$1000	$520	$271	$146	$63

To help simplify the transition, the SEC staff indicated that companies that previously accrued compensation for awards to retirement-eligible employees over an expected service period should continue to apply their historical accounting policy for previous awards, with appropriate disclosure. They would apply the requirement of Statement 123(R) prospectively to new grants awarded after adoption.

As a simple example, assume that a company awards options that vest (becomes exercisable) at the end of two years of service to an employee who is already eligible to retire at the date of grant. If the employee retires, the options still vest (become exercisable) two years after grant. There are no other performance, service or market conditions associated with the award. Statement 123(R) would consider the award's explicit service period (the stated two-year vesting period) to be nonsubstantive, because the employee can retire at any time and receive the benefit of the options. That is, the employee is not required to render any service to enjoy the benefits of the options. In this scenario, the company should recognize as compensation the entire fair value of the award at the date of grant. Similar guidance was originally set forth in Issue 19 of EITF Issue No. 00-23, *Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44*, and is carried forward by Statement 123(R).[7]

Going a step further, the FASB Resource Group has been asked to consider how a company should account for awards issued to retirement-eligible employees (either currently eligible or that will become eligible during the explicit service period) that also contain performance conditions that may be substantive (e.g., cumulative net income targets over five years) with regard to estimating the requisite service period. To date, no consensus has been reached, but the Resource Group may discuss this topic at a future meeting.

How Statement 123(R) differs from Opinion 25. Opinion 25 has similar concepts in that compensation is accrued over the service period and zero compensation is recorded for forfeited awards. However, Opinion 25 has no specific requirement to estimate vesting or for how or when to reflect forfeitures. For awards with graded vesting, Opinion 25 requires separate accounting by tranche only for variable awards (those for which either the price the employee must pay or the number of shares is not known at date of grant). For fixed awards (those for which both the price the employee must pay and the number of shares are known at date of grant), practice predominantly treats the entire award as a unit and amortizes compensation expense over the period to the last vesting date.

How Statement 123(R) differs from Statement 123. Statement 123 has similar concepts in that compensation is accrued over the service period and zero compensation is recorded for forfeited awards. However, Statement 123 permits employers to accrue compensation for 100% of awards and record reversals of compensation as employees forfeit or to estimate the number of awards that will vest. Statement 123(R) eliminates that choice. For awards with graded vesting, Statement 123 permits employers a choice between accounting for the entire award as a unit or accounting for the individual tranches. Statement 123(R) retains that choice. Statement 123(R) introduces the term requisite service period and the requirement to derive a make-believe service period for awards with market conditions.

What is the impact of service, performance and market conditions?

Impact of service, performance and market conditions – Key Points:

- Under Opinion 25, grants with performance or market conditions triggered variable accounting.

[7] Refer to Statement 123(R), paragraphs A57-A58.

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- Under Statement 123(R), measurement of equity awards is generally fixed at fair value at inception, yielding more favorable treatment.
- A company will need to separately assess at each reporting date the probability of achieving each service or performance condition.
- Recognize compensation cost only if requisite service is rendered.

Employee awards may require satisfaction of one or more service, performance or market conditions or a combination thereof. The FASB makes a distinction in Statement 123(R) between performance and service conditions that affect vesting and exercisability and those that affect factors other than vesting or exercisability (e.g., factors affecting exercise price, contractual term, quantity, conversion ratio, etc.).

Market, performance and service conditions that affect vesting or exercisability[8]

In general, compensation cost is recognized if the requisite service is rendered. Performance or service conditions that affect vesting are not reflected in estimating the fair value of an award at the grant date as they represent restrictions that stem from the forfeitability of awards to which the employees have not yet earned the right. However, a market condition affecting vesting would be reflected in the grant-date fair value. Stated differently, service or performance conditions do not affect the per share or per option fair value of an award. Instead, service or performance conditions affect compensation expense to the extent that they cause employees to forfeit awards, because no compensation is recorded for forfeited awards, but they do not reduce the value of the individual shares or options. By contrast, market conditions do reduce the per share or per option fair value of an award, but if the employee renders the requisite service (works for the entire make-believe service period), compensation expense is recorded for the entire award even if the market condition is not satisfied. Statement 123(R) provides several illustrations of awards that contain market, performance and service conditions or a combination thereof that affect vesting or exercisability in Appendix A. Page 14 illustrates the accounting for an award containing both a performance and a service condition. Page 15 illustrates the accounting for an award containing a market condition.

Practically speaking, Statement 123(R) requires a company to typically perform the following steps in determining the appropriate amount of compensation expense to recognize and over what period to recognize it for equity awards that contain market, performance and service conditions affecting vesting or exercisability (This process has been greatly simplified for our discussion purposes):

1. Estimate the number of shares that will vest and how and over what time period they will vest (This requires an estimate of forfeiture rates that may vary over time)
2. Estimate the grant date fair value of the options.
3. Determine how to allocate expense recognition based upon probability of targets being achieved and how to track each respective tranche.
4. Assess Step 3. at each reporting date and adjust accordingly.

Market, performance and service conditions that affect factors other than vesting or exercisability[9]

For either performance and service conditions or for market conditions that affect factors *other than* vesting or exercisability, the grant-date fair value should be estimated for each possible outcome of such conditions and the final measure of compensation cost should be based on the amount estimated at grant date for the condition or outcome that is actually satisfied. Statement 123(R) provides several in-depth illustrations in Appendix A.

How Statement 123(R) differs from Opinion 25. Opinion 25 treated grants of awards with performance or market conditions as variable awards requiring variable accounting. Statement 123(R) generally allows for fixed accounting for equity awards and thus, we would expect to see more performance or market conditions being incorporated in future award grants.

How Statement 123(R) differs from Statement 123. Statement 123(R) retains the modified grant-date approach of Statement 123 and accounting for service, performance, and market conditions is similar under both standards. Also like Statement 123, the effect of a market condition on vesting (for example, an option that becomes exercisable only if the stock price exceeds a certain amount) is factored into the fair value estimate, and compensation is not reversed if the award never vests because the target condition is not reached. Statement 123(R) introduces the

[8] Refer to Statement 123(R), page 57, "Accounting for Awards with Market, Performance, or Service Conditions" for a flowchart that depicts the accounting for an award based on the existence of market, performance or service conditions (or any combination thereof).

[9] See footnote 8.

An award containing both a performance and a service condition that affect vesting:

By way of example, let's assume Company A grants options to purchase one million shares to 100 employees on January 1, 2006 with an exercise price of $8 per share (based on the market price on that date). The estimated fair value of the options is $4 million. Half of the options are linked to performance targets for Year 1, and half are linked to performance targets in Year 2. The options become exercisable if the performance targets are met, *and* the employee remains employed for 4 years from date of grant.Company A needs to determine the amount of compensation expense to recognize for each reporting period given the following additional information:

- At March 31, 2006, Company A believes it is probable that the performance targets will be met in both years and estimates a 5% forfeiture rate for this group of employees.
- At September 30, 2006 due to poor quarterly results, Company A concludes it is no longer probable that the Year 1 performance targets will be met.
- At December 31, 2007, Year 2 performance targets are met.

Solution: Compensation expense to be recorded:

	Shares	FV	FV expected to Vest	2006				2007	2008	2009	Total	Notes
				Q1	Q2	Q3	Q4					
Q1 2006												
Year 1 targets	500,000	$2,000,000	$1,629,013	$101,813								(a)
Year 2 target	500,000	2,000,000	$1,629,013	101,813								(b)
	1,000,000	4,000,000										
Q2 2006					101,813							
					101,813							
Q3 2006						(203,626)						(c)
						101,813						(d)
Q4 2006							101,813					
2007								–				
								407,253				
2008									–			
									407,253			
2009										–		
										407,253		
Total			$3,258,025	$203,627	$203,627	$(101,813)	$101,813	$407,253	$407,253	$407,253	$1,629,013	

a. Q1 expense = 1/16 of FV of options expected to vest at end of Year 4. Computed as FV of options multiplied by expected forfeiture rate of 5% over 4-year vesting period [($2,000,000)*.95*.95*.95*.95].
b. Q1 expense = 1/16 of FV of options expected to vest at end of Year 4.
c. When achievement of Year 1 targets no longer is probable, all prior expense is reversed.
d. Continue to recognize compensation associated with Year 2 targets.

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An award containing a market condition affecting exercisability:

By way of example, let's assume Company A grants 1,000 fully vested options to an employee with an exercise price of $10 (which equals market price on date of grant) that are exercisable if the Company's stock price equals or exceeds $15 for 20 consecutive business days prior to termination of the employee. The make-believe service period is 3 years and the estimated fair value of each option is $4 using an option-pricing model. Determine the amount of compensation expense that Company A should record in each of the following scenarios:

1. The employee works 3 years and the stock price exceeds $15 for 20 consecutive days before the employee terminates.
2. The employee works less than 3 years and the stock price exceeds $15 for 20 consecutive days before the employee terminates.
3. The employee works 3 years and the stock price does not exceed $15 for 20 consecutive days before the employee terminates.
4. The employee works less than 3 years and the stock price does not exceed $15 for 20 consecutive days before the employee terminates.

Solution: Compensation expense to be recorded:

	Stock price >$15	**Stock price <$15**
Employee works 3 years or more	Scenario 1 = $4,000	Scenario 3 = $4,000
Employee works less than 3 years	Scenario 2 = $4,000	Scenario 4 = $0

This example depicts a market condition affecting the exercisability of the option. Under this type of award, the Company should recognize compensation expense if the employee renders the requisite service (i.e., make-believe service period in this example is 3 years) ***or*** if the market condition is satisfied (i.e., the stock price exceeds $15 for 20 consecutive days prior to the employee terminating). In Scenario 1, both the conditions are satisfied and in Scenarios 2 and 3 either the service period is satisfied or the market condition is satisfied. Therefore, compensation expense would be recorded under Scenarios 1 – 3. Any expense previously recognized would be reversed ***only if*** the requisite service is not rendered ***and*** the market condition is not satisfied, which is the case under Scenario 4.

Note: The make-believe service period would shorten from the derived 3-year period if the market condition is satisfied in less than 3 years (Scenario 2), and compensation expense would be accelerated.

concept of a make-believe (derived) service period for awards with market conditions.

What about nonvested and restricted shares?

Statement 123(R) differentiates between *nonvested* shares and *restricted* shares. Nonvested shares, as defined in Statement 123(R), are shares granted to an employee that contain only a risk of forfeiture (i.e., the employee must hold the shares until he satisfies the service or performance conditions and is unable to sell them during that period. If the employee fails to satisfy the service or performance conditions [forfeits the award], the shares are returned to the company). The fair value of nonvested shares is the quoted market price of the shares. In Statement 123(R) terminology, restricted shares are shares that will be restricted from resale even after an employee has a vested right to them (e.g., a requirement to hold the shares for five years after vesting). The fair value of restricted shares is less than the quoted market price of unrestricted shares. Fair value should reflect the amount at which a similarly restricted share would be sold to an independent party. The restriction of the shares after vesting effectively reduces the fair value associated with those shares.

How are modifications of grants treated?

A modification is defined broadly as any change to an award's terms, including exercise price, number of shares, life, vesting conditions, settlement provisions, etc. Modifications encompass changes in conjunction with an equity restructuring, such as a spin-off, stock split or div-

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idend, rights offering, or large nonrecurring cash dividend. Modifications may result from original performance targets being set too high, changes in business plans or restructuring, assignment of new job duties, change in control leading to acceleration of vesting, or acceleration of vesting in contemplation of retirement. Other types might include modifications to change an award's classification from liability to equity or vice versa or to serve as inducement for certain behavior (e.g., lower exercise price if employees exercise within the next 30 days).

A modification is viewed as the cancellation of the original award in exchange for the modified award. As a result, for equity awards, compensation cannot be less than the original grant date estimate of fair value, unless the original award was likely to be forfeited. If the fair value of the modified award exceeds the fair value of the original award as of the modification date (not the fair value as of the grant date), the incremental fair value, plus any remaining unamortized compensation from the grant date valuation of the original award, are combined and amortized over the remaining vesting period of the modified award (or charged off immediately if there is no remaining vesting period). Total recognized compensation cost for a modified award should be at least equal to the fair value of the award at grant unless, at modification, performance or service conditions of the original award are not expected to be satisfied. A key point to consider here is the effect of the modification on the number of instruments expected to vest.

Practical note: *If the value of an award drops after grant date because a company's stock price declines, can the company modify its outstanding awards to trigger a new measurement of compensation at the new, lower stock price?*

For liability awards, fair value is remeasured every period and would decrease as the stock price declines. For equity awards, fair value is not remeasured after grant date. For equity awards it generally is impossible to trigger a new, lower measure of fair value, because Statement 123(R) states that total compensation cost cannot be less than the fair value measured at grant date. The one exception is that if it appears probable that the original award is going to be forfeited, then compensation would be zeroed out on the original award and compensation on the new award would be measured at the new, lower stock price.

How Statement 123(R) *differs from Opinion* 25. Because the Opinion 25 model is so different from the fair value model, modifications are treated very differently under Opinion 25, and it is difficult to make a meaningful comparison. In 2000 and 2001, the FASB and the EITF provided extensive guidance on accounting for modifications under Opinion 25.

How Statement 123(R) *differs from Statement* 123. Accounting for modifications under Statement 123 is similar in concept to the accounting under Statement 123(R). As a result of the extensive recent work on accounting for different kinds of modifications under Opinion 25, Statement 123(R) contains more examples of modifications and more implementation guidance than Statement 123.

How are changes in estimates treated?

Statement 123(R) requires a company to make its initial estimate of the requisite service period at the grant date (or the service inception date if that date precedes the grant date). A company may then adjust that initial estimate in light of changes in facts and circumstances. A change in the estimate of requisite service period under Statement 123(R) may be treated prospectively or as a cumulative catch up adjustment in the period of change depending on the nature of the change. Statement 123(R) distinguishes between the accounting for changes in estimates as follows:

1. *Changes to outcomes affecting the grant date fair value or quantity of instruments that vest* (e.g., change in exercise price, a vesting condition becoming probable, or an increase/decrease in the number of instruments expected to be forfeited). These types of changes are accounted for in the period of change as a cumulative effect adjustment on the current and prior periods, as if the change had been known at the grant date. To illustrate, assume a company grants 100 options with an exercise price of $20 per share that vest over three years if the company reaches certain targeted earnings goals. During year 2, the company realizes that it probably will not reach its earnings goal for the year and thus, should revise its estimate of the number of options that will be forfeited. To account for this change in estimate, the company would record a cumulative catch-up adjustment to reverse the compensation cost previously accrued relating to the options previously expected to vest.
2. *Changes to the requisite employee service period for which compensation cost is already being attributed* (e.g., an initially estimated requisite service period changes because a different market, performance, or service condition becomes the basis

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for the requisite service period). These types of changes require any unrecognized compensation cost at the date of change to be recognized prospectively over the revised requisite service period, if any. To illustrate, assume that a company grants options with a grant date fair value of $1,000 that vest if the company achieves Stage II clinical trials for its product. For each of the first two years, the company expects to achieve this goal in five years. The company applies straight-line amortization and records $200 of compensation expense in years 1 and 2. In year 3, the company believes that it will now take six years (from the date of grant) to achieve the performance condition. While there is no change to the grant-date fair value of the award, the company should revise its estimate and recognize the remaining compensation expense of $600 prospectively over the remaining four years of the revised implied service period at $150 per year.

As a reminder, the ultimate goal of Statement 123(R) is that the final measure of compensation cost for an equity award should be based on the amount estimated at the grant date for the condition or outcome that is actually satisfied.

How are income tax benefits accounted for?

Statement 123(R), taken together with FASB Statement No. 109, *Accounting for Income Taxes* and FASB Statement No. 95, *Statement of Cash Flows*, contains requirements and guidance to account for differences in timing and amounts between the income tax return deductions for share-based payment awards and the compensation expense recognized for financial statement reporting purposes.

Accounting for Three Types of Awards

In terms of income tax benefits associated with share-based payment awards, generally there are three types of awards: (1) equity awards under Statement 123(R) that ordinarily trigger an income tax deduction (e.g., restricted stock or non-qualified options); (2) equity awards under Statement 123(R) that ordinarily do not trigger an income tax deduction but through a future event, such as an employee's disqualifying disposition of shares, can give rise to a tax deduction (e.g., incentive stock options (ISOs) and Internal Revenue Code Section 423 qualified Employee Stock Purchase Plans (ESPPs)); and (3) liability awards under Statement 123(R). Of the three, type (1) is the most prevalent and most difficult to account for.

(1) *Accounting for equity awards that ordinarily trigger an income tax benefit.*

Currently, income tax deductions are measured at vesting date (for shares) or exercise date (for options), based on the intrinsic value at that date.[10] Both the measurement date and the measurement method used for income tax purposes differ from Statement 123(R), so the tax deduction (to be treated as a temporary difference for purposes of applying Statement 109) inevitably will differ from the compensation expense recorded for accounting purposes. An employer accrues an income tax benefit and a deferred tax asset as it accrues compensation expense and assesses the deferred tax asset for realizability, as is done for other deferred tax assets under Statement 109.[11] If the actual tax deduction exceeds the compensation expense accrued for accounting purposes under Statement 123(R), the excess tax benefit ("windfall") is credited to additional paid-in capital (APIC) when it is *realized*. If the actual tax deduction is less than the compensation expense accrued for accounting purposes, then the unrealized portion of the deferred tax asset ("shortfall") is offset against prior excess credits to APIC; the remainder is charged-off to income tax expense. An employer needs to track tax benefits for each individual award, but the computation of a windfall or shortfall is made on an aggregate basis for all options exercised (or restricted shares that vest) in a year.

To summarize, Statement 123(R) carries forward from prior standards (both Opinion 25 and Statement 123) the principle that the income tax benefit from an income tax deduction in excess of compensation expense for financial reporting purposes should be credited to APIC, not to the provision for income taxes. When the reverse situation occurs, (e.g., an income tax deduction that is less than compensation expense for financial reporting purposes), the shortfall is charged against APIC to the extent of prior credits, and the remainder of the shortfall, if any, is charged to income. The key point is that the income tax benefit recorded in earnings is equal to the lesser of (a) the actual tax benefit realized on the tax return or (b) the cumulative compensation expense for financial reporting purposes multiplied by the statutory income tax rate.

While the principle is the same, the application is more complex than under Opinion 25 for two reasons. First, for an option with zero com-

[10] For shares, an employee can elect under Section 83 of the Internal Revenue Code to be taxed at grant date, in which case the employer receives a tax deduction at the same time.

[11] In assessing realizability, the employer should consider the likelihood of future taxable income but should not consider the current stock price.

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pensation expense under Opinion 25, a shortfall was impossible, and the entire tax benefit was a windfall. Under Statements 123 and 123(R), shortfalls can occur whenever the stock price languishes during an option's life, and a windfall will be only part of the tax benefit. Second, Statement 123(R) allows windfalls to be recognized only when they are realized. While Opinion 25 and Statement 123 had similar language, the FASB staff informally advised accountants that windfalls should be recognized based on the normal recognition threshold (more likely than not) in Statement 109. Statement 123(R) imposes a different, higher threshold (realized) on excess tax deductions from share-based payment transactions, which requires substantially more recordkeeping.

(2) *Accounting for equity awards that ordinarily do not generate an income tax benefit*

If the award is of a type that ordinarily would not generate an income tax benefit, such as an incentive stock option (ISO) as defined in Section 422 of the Internal Revenue Code, the compensation accrued for financial reporting purposes is not a temporary difference, and the employer records no deferred tax asset as it accrues compensation for financial reporting. If the employee makes a disqualifying disposition and the employer receives a tax deduction, the amount of tax benefit reported in earnings is limited to the lesser of (a) the actual tax benefit received or (b) the cumulative compensation expense for financial reporting purposes multiplied by the statutory income tax rate, similar to the limitation for awards that ordinarily generate an income tax benefit.

Note: The FASB Resource Group discussed the situation when the amount of the deduction that results from a disqualifying disposition is less then the compensation cost recorded and concluded that the reduction in income taxes payable as a result of a disqualifying disposition should be limited to the actual deduction received, with no drawdown of prior credits to APIC.[12]

(3) *Accounting for liability awards*

For awards classified as liabilities under Statement 123(R), the tax deduction generally will equal the cumulative compensation expense for financial reporting purposes, but the timing will differ. The compensation deduction will be taken upon exercise or settlement, whereas the compensation expense for financial reporting will be recorded ratably over the requisite service period and then adjusted each period from the end of the requisite service period until exercise or settlement. Therefore, the employer treats the accrued liability as a temporary difference and records a tax benefit and deferred tax asset as it accrues compensation for financial reporting purposes. The deferred tax asset is assessed for realizability like other deferred tax assets under Statement 109.

For the remainder of this section, we will focus primarily on equity awards that ordinarily trigger an income tax benefit. Statement 123(R) permits a pooling of amounts that are reflected in APIC (the APIC pool). However, to many companies' surprise, the beginning balance of the APIC pool under Statement 123(R) is not the actual amount the company credited to APIC in prior years. Rather, it is the hypothetical amount that the company would have credited since 1995 if it had followed the fair value method of Statement 123. Many companies do not know that hypothetical amount. In some cases, they lack that information because of corporate transactions like poolings of interest or spin-offs since 1995. In other cases, it appears that companies that continued to apply Opinion 25 and disclosed fair value information in the notes to financial statements were not as thorough as they could have been in accumulating the fair value information from year to year. Recognizing this lack of information, the FASB offered a practical transition election in FSP FAS 123(R) – 3 – "*Transition Election Related to Accounting for the Tax Effects of Share-Based Awards*," which allows a company to choose one of the following methods for calculating the pool of excess income tax benefits available to absorb shortfalls recognized subsequent to adoption of Statement 123(R):

1. Include net excess benefits that would have qualified had the company adopted Statement 123 for recognition purposes starting in 1995 (Refer to Paragraph 81 of Statement 123(R)) (the regular method);

OR

2. At adoption of Statement 123(R), calculate the beginning APIC pool as:
   - All increases to APIC related to stock compensation tax benefits recognized in a company's financial statements for periods subsequent to adoption of Statement123 but prior to adoption of Statement 123(R), less
   - For awards that vested before adoption of Statement 123(R), cumulative incremental gross compensation cost that would have been recognized under the fair value method of Statement 123 multiplied by the company's

[12] Refer to the Statement 123(R) Resource Group Meeting No. 2 – July 21, 2005 - Issue 6a) – 6c)

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current blended statutory tax rate (the short-cut method).

The guidance in this FSP is to be applied as of initial adoption of Statement 123(R), but companies have a one-year "grace period" to choose their method.

Awards that are partially vested upon adoption should be excluded from the short-cut computation above. For a partially vested awards, a company will compare the tax deduction to the sum of compensation cost recognized for that award under Statement 123(R) plus the compensation cost disclosed for that award under Statement 123. For both fully vested and partially vested awards, the tax effect of any resulting excess deduction for tax purposes should increase the APIC pool; the tax effect of any resulting deficient deduction for tax purposes should be deducted from the APIC pool.

Private companies

As discussed later, private companies generally will apply Statement 123(R) prospectively to new awards. In this situation, they start a new APIC pool for awards accounted for under Statement 123(R) that is separate from the APIC pool created under Opinion 25.

Accounting for tax loss carry forwards

As noted previously, Statement 123(R) specifically prohibits recognition of windfall tax benefits that have not been realized. That is, no deferred tax assets may be recorded for the portion of a net operating loss (NOL) carry forward created by windfall tax benefits.[13] In this situation, a tax benefit and accompanying credit to APIC for the excess deduction would not be recognized until the deduction reduces taxes payable. Upon adoption of Statement 123(R), any existing deferred tax assets related to NOL carryforwards created by windfall tax benefits and the related credits to APIC continue to be recorded, but those credits to APIC are not included in the pool of available benefits to absorb deficiencies. Those credits may only be included in the APIC pool when the NOL carryforward is subsequently realized as a reduction of taxes payable.

If a company has NOL carryforwards from operating losses and NOL carryforwards from windfall tax benefits from stock compensation awards, which NOLs are used first? The FASB Resource Group discussed how Statement 123(R) interacts with the intraperiod allocation rules under Statement 109.[14] The Resource Group reached a consensus that a company may make a policy election to either follow the "with-and-without" approach described in EITF Topic D-32, "Intraperiod Tax Allocation of the Tax Effect of Pretax Income from Continuing Operations" or the tax return approach in determining the order in which NOL carryforwards are used to reduce taxes payable. Under the with-and-without approach, the NOL carryforwards from windfall tax benefits are considered realized only if they provide an incremental benefit after considering all other tax attributes presently available to the company (i.e., windfall tax benefits are considered last). Under the tax return approach, NOL carryforwards are considered realized based on the ordering of NOLs under tax law. The policy election should be consistently applied and disclosed.

The Resource Group intends to consider whether and how the direct impacts of the deductions related to share-based payments should be considered in applying the with-and-without method at a future meeting.

Accounting for income taxes in interim periods

The FASB Resource Group also addressed how deficiencies should be accounted for and reported in interim financial statements.[15] The Resource Group reached a consensus that the comparison of tax deductions to compensation expense for financial reporting purposes is an annual computation based on options exercised and shares vested that year. Therefore, shortfalls should be recognized as part of the tax provision in the interim periods in which they are incurred but reversed to the extent windfalls occur in subsequent interim periods within the same year. The Resource Group reached a consensus that it would be inappropriate for companies to anticipate the effects of vesting or exercises later in the year. Shortfalls would be treated as "discrete" events and would not be included in estimating the annual effective tax rate. Likewise, estimations of future deficiencies (e.g., resulting from existing deep out-of-the money options that will expire later in the current year) should not be considered in estimating the effective tax rate.

Practical note: Companies should be assessing current processes and physical tracking mechanisms in preparation for the significant income tax accounting changes posed by adoption of Statement 123(R).

How Statement 123(R) differs from Opinion 25. Because most stock options have zero compensation expense under Opinion 25, there is no need to

[13] Refer to Statement 123(R) paragraph 81 and footnote 82 to paragraph A94.
[14] Refer to Refer to the Statement 123(R) Resource Document Meeting No. 3 – September 13, 2005, Issue 1.
[15] Refer to the Statement 123(R) Resource Group Meeting No. 2 – July 21, 2005, Issues 7a)-7c).

record deferred tax assets, and there is no possibility that the tax deduction could be smaller than the cumulative compensation expense for financial reporting purposes. The tax benefit for the compensation deduction claimed on the tax return is recorded as APIC, similar to Statement 123(R). For the minority of plans that create compensation expense for financial reporting purposes that is measured differently from the tax deduction (for example, a stock option granted with an exercise price below market price on date of grant), the benefit of a tax deduction in excess of cumulative compensation for financial reporting is credited to APIC. If the tax deduction is less than cumulative compensation for financial reporting, the shortfall is charged to APIC to the extent of prior credits to APIC. Any shortfall in excess of prior credits to APIC is charged to income tax expense.

How Statement 123(R) differs from Statement 123. The limitation that windfall tax benefits may be recorded only when realized, rather than following the recognition guidance of Statement 109, is new. In other respects the accounting for income taxes in Statement 123(R) is similar to Statement 123.

How are cash flow statements affected?

The income tax benefit from option exercises can substantially reduce or eliminate a company's current tax liability. Under FASB Statement No. 95, *Statement of Cash Flows*, and EITF Issue No. 00-15, "Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option," the entire tax benefit, whether recorded in earnings or APIC, is an operating cash flow. Under Statement 123(R), excess tax benefits will be treated as a financing cash inflow rather than an operating cash inflow. As noted previously, for purposes of computing the income tax provision, the analysis of excess or deficient tax benefits is performed on an aggregate basis for all options exercised and all shares vested in a year. By contrast, for the cash flow statement, the analysis of excess or deficient tax benefits is performed on an individual grant basis. That is, the excess tax benefits for each individual grant with an excess tax benefit are aggregated to compute the amount of tax benefit treated as a financing cash inflow, with no offset for individual grants with deficient tax benefits. For example, assume that two stock options are exercised in 2006, one with an excess tax benefit of $100 and the other with a shortfall of $80. The excess and the shortfall are netted for purposes of computing the tax provision and the credit to APIC, and a net $20 would be added to APIC. On the cash flow statement, the $100 excess tax benefit will be reflected as a financing cash inflow; the $80 shortfall will not be netted. Thus, a company needs records and procedures to track this information on an individual grant basis.

Practical note: Companies should be mindful of the potential quantitative effect on operating cash flow, because the change may have an impact on compliance with debt covenants or on ratios or other measurements that use cash flow information.

How are EPS computations affected?

Guidance on earnings per share (EPS) computations is provided by FASB Statement No. 128, *Earnings Per Share*. Statement 128 requires options, nonvested and restricted shares, and other awards granted to employees to be treated as potential common stock in computing diluted EPS using the treasury stock method. This calculation is based upon the actual number of shares or options granted and not forfeited, without reduction for expected forfeitures. That is, EPS computations are based on the full number of outstanding awards, whereas compensation expense is accrued only for awards expected to vest. Under the treasury stock method, proceeds include the following:

- Amount employee will pay, if any, plus
- Unearned compensation, if any, plus or (minus)
- The amount of tax benefit that would be credited or (debited) to APIC if the tax deduction were measured based on the current stock price.

Statement 128 treats awards that are contingent on performance or market conditions as contingently issuable shares.

While Statement 123(R) does not change the mechanics of the computations for diluted earnings per share (EPS), it poses some challenges that companies need to be aware of. In particular, companies that granted predominantly options that had zero compensation expense under Opinion 25 had no unearned compensation and no deficient tax benefits to reflect in EPS computations in the past. Although companies had excess tax benefits, some ignored the excess tax benefits in computing diluted EPS. Under Statement 123(R), those companies should upgrade their EPS computations to capture unearned compensation and excess and deficient tax benefits.

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As mentioned previously, the FASB's Statement 123(R) Resource Group is wrestling with some narrowly-defined issues. Two of these relate to EPS computations.[16] In particular, the Resource Group has discussed and provided guidance relating to the following:

- Question: *How should a company compute diluted* EPS *for share-based payment awards that are currently out-of-the-money* (*i.e., exercise price is greater than the average market price*) *if the tax deficiency that would be debited to* APIC (*and therefore would serve to reduce assumed proceeds*) *would make the award dilutive*?
- Answer: The treasury stock method was only intended to capture awards that would actually be exercised and converted into common shares. Therefore, out-of-the-money awards would be excluded from the computation.
- Question: *For awards granted prior to transition to* Statement 123(R), *should adjustments for excess deferred tax benefits or deferred tax asset write-offs affecting* APIC *be* (*a*) *based on amounts that would actually be recognized or* (*b*) *adjusted for any pro forma deferred tax assets*?
- Answer: Originally the Resource Group indicated companies should follow pro forma balances as if the company always had been following a fair value measurement principle. However, in light of the permitted short-cut method to compute the opening balance of the APIC pool, the Resource Group plans to reconsider this guidance in a future meeting.

What are other implementation issues to consider?

Previously, we noted that Statement 123(R) requires companies to record no compensation expense for forfeitures of awards and on an ongoing basis to estimate how many forfeitures it anticipates. In the end, forfeitures will be adjusted to actual experience. The hurdle here is adequately estimating forfeitures and recognizing that actual experience may differ from estimates and may have a significant impact on compensation recorded.

Consideration of the quality of the data available to estimate the expected terms of options and the expected volatility of the company's stock price is another implementation issue that may pose difficulties for some companies. For example, both estimates would require careful analysis of periods in which swings in stock price or exercise behavior may have been influenced by or attributable to extraordinary market conditions or events that are infrequent in nature and should be excluded from consideration. Employee exercise and termination behavior may differ among various groups of workers (e.g., salaried versus hourly). Blackout periods as well as non-transferability or other restrictions on awards are additional factors that may affect the expected term of options.

A company also may encounter situations in which the grant date of an award may differ from the date the employee begins rendering service. For example, an employee may begin rendering service before some of the critical terms of the award have been set. Under this scenario, a company would begin accruing compensation even though the grant date has not yet occurred (assuming all necessary approvals to grant the award have been obtained). Alternatively, the directors may have granted an award subject to shareholder approval, and the employee may begin to render service. Under this scenario, a company would not start accruing compensation until shareholder approval is obtained, unless approval is a formality because the directors own a majority of the outstanding shares.

If a company grants share-based payment awards to employees whose compensation is capitalized in inventory, self-constructed assets, internally developed software, etc., then the compensation from their share-based payments awards should be capitalized to the same extent as their cash salary and fringe benefits. Companies may need to develop new systems to capture the amounts to be capitalized. Alternatively, as suggested in SAB 107, it may be possible to make reasonable approximations of the amount of share-based compensation to be capitalized without revising existing cost capitalization systems.

In terms of processes to consider when implementing Statement 123(R), the monitoring and tracking of option information (e.g., exercise behavior, consideration of blackout periods when formulating lattice model estimates, impact of post-vesting behavior, etc.) along with the estimation of service and performance condition outcomes (e.g., employee turnover or forfeiture rates, likelihood of performance criteria being satisfied, etc.) require a company to assess how well its processes are designed and how well they may be working. Considerations in this area become especially important in light of the internal control reporting requirements under Section 404 of the Sarbanes-Oxley Act.

Other more obvious considerations include the appropriateness of software being used to value the

[16] Refer to the Statement 123(R) Resource Group Meeting No. 3 – September 13, 2005, General Implementation Matters – Issues 2 and 3.

options and spread compensation expense and whether the award agreements have been thoroughly read and their provisions captured in the valuation methodology being employed.

Finally, companies will need to consider the impact that fair value accounting for share-based payment awards will have on financial ratios, including compliance with debt covenants, and budgets during their corporate planning processes.

What are issues that private and small public companies should focus on?

Keeping in mind that one size does not fit all, accounting for share-based payment may pose some additional complications for smaller companies that may not have sufficient historical data or means of analyzing and tracking that data. For example, estimation of vesting and forfeitures may pose challenges for those companies that may not have an established pattern of employee turnover or may not have a well-designed system in place for tracking forfeiture behavior. Even smaller companies that have the data may not feel that the employee base is large enough for that data to be predictive. As mentioned previously, private companies may now need to rely on the historical volatility of comparable public companies or sector indices to estimate expected volatility if they do not have adequate basis to estimate the expected volatility of their own stock price. Under Statement 123, private companies could use the minimum value method with zero volatility. Selection of an appropriate index will pose the most difficulty as a company will need to consider multiple factors including: (a) how closely the operations of the companies within the index mirror the company's own operations, (b) business life cycles of the companies that comprise the index, (c) relative sizes of the companies that comprise the index, and (d) availability of more frequent pricing observations. A company that operates in a variety of different industry sectors may need to consider selecting multiple indices and then weighting them in accordance with the nature of its own operations.

What disclosures should be presented?

Statement 123(R) sets forth four objectives of disclosure, and specifies the minimum disclosures necessary to achieve those objectives. The objectives are to enable the readers of the financial statements to understand (1) the nature and general terms of the arrangements in existence and the potential effects on the shareholders, (2) the compensation expense reported in income, (3) the methods used to estimate fair value, and (4) the cash flow effects. The minimum disclosures are as follows:

1. A description of the arrangements in existence—general terms, required employee service periods and other vesting conditions, maximum contractual term, and number of authorized shares.
2. For the most recent year, a rollforward of the share and option awards outstanding from the beginning of the year to the end of the year showing the activity (new grants, exercises, forfeitures, and expirations), with supplemental disclosure of how many options outstanding at the end of the year are currently exercisable. The rollforward should present weighted-average exercise prices for options and weighted-average grant-date fair values for shares.
3. For each year for which an income statement is presented, the weighted-average grant date fair values of awards granted (or calculated value for private companies electing that alternative or intrinsic value, as applicable) and the total intrinsic value of options exercised, share-based liabilities paid, and the total fair value of shares vested during the year.
4. For stock options that are vested at the latest balance sheet date or expected to vest, the number, weighted-average exercise price, aggregate intrinsic value, and weighted average remaining contractual term, with separate disclosure of total options and vested options.
5. The preceding disclosures should be presented separately for different types of awards, for example, options with fixed versus indexed exercise prices, options with only service conditions versus options with performance conditions, or awards classified as liabilities versus equity.
6. For each year for which an income statement is presented, a description of the method used to estimate fair value[17] (or calculated value), a description of the significant assumptions used (expected term, expected volatility, expected dividends, risk-free rates, and discounts for post-vesting restrictions), total compensation cost included in income, total related income tax effect included in income, total compensation cost capitalized in the cost of assets, and a description of significant modifications.
7. As of the latest balance sheet date, total compensation cost to be

[17] The fair value disclosures would not apply to liability awards of private companies measured at intrinsic value.

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recorded in future years related to nonvested awards and the weighted-average period over which it will be recorded.

8. The amount of cash received from exercise of share options, the excess tax benefit recorded in APIC, and the amount of cash used to settle equity grants during the annual period.
9. The company's policy for obtaining shares to be issued upon exercise of options and, if the policy is to purchase treasury shares for this purpose, the estimated number of shares to be repurchased in the next year.

How Statement 123(R) differs from Statement 123[18]. The FASB has both added and deleted disclosures and has modified some of the continuing disclosures. The major changes include:

Deletions

- Going forward, there is no need for pro forma disclosure of earnings and EPS under the fair value method, because substantially all employers will be applying the fair value method in their income statements. The pro forma disclosures for prior years presented for comparative purposes will continue to be required (except for private companies that used minimum value for pro forma disclosures).
- The rollforwards (disclosure 2 above) are required only for the most recent year instead of all years for which an income statement is presented. In addition, it is no longer necessary to disclose the range of exercise prices for options outstanding at the latest balance sheet date.
- The weighted-average grant-date fair values (disclosure 3 above) no longer need to be disclosed separately for options that are in the money, at the money, or out of the money at grant date[19].

Additions

- Disclosures 4, 7, 8, and 9 above are new requirements.
- The disclosure of the total intrinsic value of options exercised or shares vested (last part of disclosure 3) is a new requirement.
- In disclosure 6, the disclosures of the method used to estimate fair value or calculated value, related income tax effect included in income, and cost capitalized in the cost of assets are new requirements.

As a reminder, SAB 107 indicates that the SEC staff expects robust disclosures within Management's Discussion & Analysis (MD&A) regarding the impact of Statement 123(R) due to potential significant differences between pre- and post-adoption income statements and cash flow statements that may make the financial statements noncomparable. These disclosures also should include discussion about changes in the nature or quantity of awards and the impact those changes will have on future compensation expense.

Disclosures in quarterly financial statements

SEC regulations presume that a reader of a Form 10-Q has access to a copy of the most recent Form 10-K, so it is unnecessary to repeat disclosures from the latest Form 10-K in the subsequent year's Form 10-Q. For companies adopting Statement 123(R) in the first quarter of the fiscal year beginning after June 15, 2005, the latest Form 10-K does not contain the incremental Statement 123(R) disclosures. Therefore, registrants should include the incremental Statement 123(R) disclosures in each Form 10-Q in the first year of adoption. In some cases, the incremental Statement 123(R) disclosures will be more understandable in conjunction with some of the carryover disclosures, so companies may choose to present more than the minimum requirements in the Form 10-Q for readability.

Note: *Non-GAAP financial measures and classification of share-based payment on the income statement*: SAB 107 reminds registrants that share-based payments are compensation and should be treated as such in the income statement. If a company wants to highlight the fact that reported compensation expense includes a non-cash component for share-based payment arrangements, they may do so parenthetically within a caption in the income statement or within the notes to the financial statements or by discussion in MD&A. Presenting the expense for share-based payments on a line separate from other compensation, as though it is something other than compensation, is not appropriate.

If within MD&A, a company chooses to discuss earnings before the compensation charge for share-based payment awards, this is considered a non-GAAP measure. The company should comply with the SEC's rules about non-GAAP measures and ensure appropriate disclosure as to

18 All entities currently are required to present the disclosures specified in Statement 123. A comparison to the original disclosure requirements of Opinion 25 would not be relevant.

19 An in-the-money option has an exercise price lower than the market price of the shares, an at-the-money option has an exercise price equal to the market price of the shares, and an out-of-the-money option has an exercise price greater than the market price of the shares.

why the company believes this is a useful measure, reconcile to the most comparable GAAP measure, and make relevant explanations of the measurement.

SAB 107 also highlights disclosures that the SEC staff would expect MD&A to include with regard to share-based payment arrangements:

- accounting method used prior to and upon transition and the impact on earnings and cash flows;
- modifications prior to adoption of Statement 123(R) (e.g., acceleration of vesting);
- differences in valuation approaches from Statement 123;
- changes in type of share-based plans (e.g., shift from share options to restricted shares) or terms;
- cumulative effect recorded at adoption; and
- total compensation cost related to nonvested awards and the weighted-average period over which it will be recognized.

Effective date and transition considerations

Statement 123(R) proposes different effective dates and transition methods for private and public companies. This summary identifies the general provisions that are relevant for most companies. A private company that already applies the fair value method under Statement 123 or a company that has grants that change from equity under Statement 123 to liability under Statement 123(R), or vice versa, faces additional issues.

Private companies. Statement 123(R) requires that private companies that utilized the minimum value method under Statement 123 adopt the new fair value accounting prospectively for new or modified grants for fiscal years beginning after December 15, 2005. Prospective adoption means that awards granted in earlier fiscal years continue to be accounted for using the existing accounting, typically Opinion 25. Private companies that elected to use the fair value method under Statement 123 will follow the same guidance as public companies outlined below.

Public companies. Public companies should adopt the new fair value accounting under the modified prospective method in fiscal years beginning after June 15, 2005. For small business (S-B) filers, the effective date is fiscal years beginning after December 15, 2005. Modified prospective means that for fiscal years beginning after June 15, 2005 (December 15, 2005 for S-B filers), (1) new grants and modified grants are accounted for in accordance with Statement 123(R) and (2) awards granted in earlier fiscal years that are not yet vested are accounted for in accordance with the fair value model of Statement 123. For companies that currently apply Opinion 25, this transition method effectively brings into the income statement for fiscal years after the effective date the compensation expense that previously would have been reported in the pro forma disclosures.

Public companies may elect to apply a modified retrospective application to periods *prior* to the effective date (e.g., either for (a) all periods for which Statement 123 was effective or (b) only prior interim periods in the year of initial adoption). Modified retrospective application requires compensation cost and related income tax effects to be accounted for under Statement 123(R), regardless of whether awards were treated as fixed or variable under Option 25. As a reminder, a company electing to apply a modified retrospective application to all prior periods will need to adjust the beginning balances of paid-in capital, deferred taxes and retained earnings and disclose such adjustments in the notes to the financial statements. Those companies applying the modified retrospective method only to interim periods in the year of adoption would not need to adjust beginning balances but should disclose the method utilized.

Practical Note: Under both the modified prospective and modified retrospective applications, no change to assumptions for previous grants would be appropriate, unless it is to correct an error. Companies are required to cease the previous policy of recognizing forfeitures as incurred and instead need to estimate forfeitures and true-up to actual. If a company previously recorded compensation expense in the income statement (either because it issued awards with compensation expense under Opinion 25, such as restricted stock or discounted options, or because it previously adopted the fair value method in its income statements, [not just in the notes]), Statement 123(R) requires a charge-off of any remaining balance sheet amounts related to the old forfeiture policy (net of tax effects and exclusive of nonrefundable dividend payments) to be treated as a cumulative effect of a change in accounting.

We expect that most public companies will choose the modified prospective method and choose to handle noncomparability through discussion within MD&A, rather than choosing retrospective application. In transitioning to the requirements of Statement 123(R) under the modified prospective application, some additional considerations include computing cumulative catch-up adjustments for the following items:

– Estimation of forfeitures for awards not yet fully vested, if the company

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previously recorded forfeitures only as they happened;

- Elimination of any contra-equity accounts relating to unearned or deferred compensation for awards issued prior to adoption of Statement 123(R);
- Determination of fair value for liability awards previously recorded under intrinsic value method; and
- Awards that are liabilities under Statement 123(R) but were treated as equity previously.

If in applying Statement 123(R) a company concludes that its pro forma disclosures reported under Statement 123 contained material errors, they will need to correct those disclosures. Detection of such errors raises a question about the adequacy of internal controls and requires the company to assess the significance of the deficiency.

If a company voluntarily adopted the fair value method in accordance with Statement 123 and FASB Statement No. 148 (As Amended), *Accounting for Stock-Based Compensation – Transition and Disclosure – An Amendment of* FASB *Statement No.* 123, it had three choices in transition—prospective, modified prospective, and retrospective. If the company chose retrospective or modified prospective at that time, it continues to apply the same accounting to past awards and to awards granted in 2004 and 2005 and applies the accounting requirements of Statement 123(R) to new awards. If the company previously chose the prospective transition method, Statement 123(R) effectively overrides that decision by requiring the modified prospective method now.

Transition Summary

Public Companies	Private Companies That Used FV Under Statement 123	Private Companies That Used Minimum Value Under Statement 123
Modified prospective method or modified retrospective method	Modified prospective method or modified retrospective method	Pure prospective method
Apply new accounting to all awards granted after effective date	Same	Apply new accounting to all awards granted after effective date
Apply Statement 123 to awards granted after 1994 but not vested as of effective date	Same	Continue to apply prior accounting to prior awards
Restatement of prior years permitted, but not required	Same	Restatement of prior years not permitted

What should companies do in response to Statement 123(R)?

The issuance of Statement 123(R) is leading some companies to reconsider the design of their equity-based employee plans. This section provides our advice on some points to keep in mind.

1. *Assess the impact on your company*. The proposed changes in accounting will affect companies differently depending on a wide range of factors such as, the current use of employee stock plans, the stage of development, risk profile, and need for entrepreneurial talent. Companies need a clear understanding of these factors, along with their objectives, so they can respond appropriately to the effects of the accounting changes on their particular facts and circumstances. Companies that have not already done so should take steps now to assess the impact of the accounting changes and consider what actions, if any, should be taken to mitigate that impact.

   In making that assessment, companies should not overreact to the changes. A compensation charge for stock options is unlikely to have the adverse effects feared by the FASB's strongest critics. Pro forma earnings and earnings per share on a fair value basis have been disclosed for 10 years. Shareholders, analysts, creditors, and others already know in general terms the impact that Statement 123(R) will have on reported earnings. Those companies that voluntarily adopted the fair value method over the past two years experienced no discernable impact on their share prices. Furthermore, because most companies will be adopting the final Statement at about the same time, no company will be at a disadvantage relative to its peers.
2. *Consider alternative compensation strategies*. It is appropriate to take a fresh look at compensation strategies in light of the new accounting guidance, but decisions should be driven primarily by what strategies provide the best incentives for employee performance and best align the interests of employees and shareholders. Accounting and income tax objectives, while important, should be subordinate to sound compensation objectives.

   Under Opinion 25, zero compensation is recorded for options with a fixed exercise price equal to market price at date of grant and no performance conditions. Many companies like that accounting result, which has helped to make such options the most common

form of equity-based employee award. However, Opinion 25 also acts as a straightjacket, because modifications to make options more effective incentives usually result in variable accounting and exposure to uncontrollable compensation charges if the stock price increases. Thus, Opinion 25 deters innovations in option design. Under Statement 123(R), compensation is measured at grant date for a broader variety of equity awards, creating a more level playing field for different option features, for example, performance conditions and exercise prices that are higher than the market price at date of grant.

Under Opinion 25, any performance condition other than employee service delays the measurement of compensation until the outcome of the condition is known. This feature effectively deters most companies from including these performance conditions. The only type of performance incentive that is at all widespread under Opinion 25 is the time-accelerated option or restricted share. Under these arrangements, vesting is accelerated if the performance condition is achieved, but the award will vest based solely on employment (for example, at the end of 10 years) if the performance condition is not achieved. Because the time-based vesting undermines the incentive effect of the performance condition, time accelerated plans likely would not exist were it not for Opinion 25. Statement 123(R) permits companies to measure compensation at grant date for awards with performance conditions.

One of the criticisms of traditional options is that they can reward mediocre performance. If a company grants its CEO a 10-year option on 100,000 shares of stock with an exercise price of $10 per share (market price on date of grant), and its stock price appreciates at 4% per year for 10 years, the CEO has a profit of about $480,000 at the end of 10 years. Given that the shareholders could have earned more than 4% per year in U.S. Treasury bonds, some critics believe that is an excessive reward. Compensation consultants have developed a number of proposals to mitigate this deficiency of traditional options. Here are several of those ideas and a summary of how they affect the accounting under Opinion 25 and Statement 123(R).

- Performance-based vesting. Exercise of the options is conditioned on meeting specific company performance criteria, such as market share growth, growth in income from continuing operations or earnings per share, or some other measure. Under Opinion 25, the number of shares is not fixed, so measurement of compensation is delayed until the performance conditions are met (variable accounting). Under Statement 123(R), the fair value of the options would be estimated at the grant date, and only the number that vest would vary.
- Premium price options. Grant options with an exercise price of $15 per share, a 50% premium over the current stock price. If the share price does not appreciate by at least 50% (thereby outperforming U.S. Treasuries), the CEO has no profit on his options. Under Opinion 25, this option also has zero compensation. Although it is more favorable to the shareholders and less generous to the CEO, the compensation expense is identical to the traditional option. Under Statement 123(R), a $15 option would have lower fair value and lower compensation expense than a $10 option.
- Indexed price options. Grant options with an exercise price of $10 per share that increases each year. If the share price does not outperform U.S. Treasuries, the CEO has no profit on his options. (The option price also could be indexed to a stock market index or to the rate of return on peer companies' shares.) Under Opinion 25, the exercise price is not fixed, so the measurement of compensation is delayed until exercise date. Under Statement 123(R), an option with an indexed exercise price would be measured at grant date and would have lower fair value and lower compensation expense than a fixed $10 option.
- Stock price hurdle. Grant options with an exercise price of $10 per share that only can be exercised if the company's share price exceeds $15 per share for 30 consecutive trading days. If the share price does not appreciate by at least 50%, the CEO cannot exercise, and cannot profit from his options. Under Opinion 25, there is an uncertainty about the CEO's right to buy the shares for a reason other than his service. As a result, the measurement of compensation is delayed until the stock price hurdle is satisfied, resulting in compensation expense of at least $500,000 it the option does become exercisable. (The compensation expense could be higher if the share price is higher than $15 on the 30th trading day.) Under Statement 123(R), an option with stock price hurdle would be measured at grant date and would have lower fair value and lower compensation expense than a fixed $10 option.

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Other changes to consider may include switching from option grants to grants of restricted stock, an action taken by Microsoft and others. Alternatively, in addition to some strategies mentioned above to reduce compensation expense, companies may want to shorten terms or exercise periods. Additionally, incorporating cashless exercise features, particularly net settlement arrangements, are attractive as they are treated as equity awards under Statement 123(R).

In light of the more narrow rules under Statement 123(R) defining noncompensatory plans, changes to broad-based employee stock purchase plans would include reducing current discounts offered from the more common 15% to the benchmark 5% "safe harbor" and also eliminating significant option features such as lookback features in order to qualify for noncompensatory treatment.

These are just a few of the many creative ideas compensation consultants have developed for better aligning the interests of employees and shareholders. Variable accounting under Opinion 25 acts as a significant deterrent to implementing these ideas. In light of Statement 123(R), companies may wish to consider changing their plans to take advantage of the expanded ability to measure compensation at grant date.

3. *Explain any changes in compensation strategy to investors*. In response to criticisms of perceived excessive option grants in the late 1990s, some companies have switched to restricted stock awards, and some investors may erroneously conclude that this strategy is preferable for all companies. We still remember that 15 years ago critics called restricted stock "pay for pulse" and said that large restricted stock grants were a sign that management was pessimistic about the company's stock price. At that time, critics touted options as the performance incentive alternative to restricted stock. Now options are falling out of favor, and restricted stock is back in vogue. Some companies are addressing the past criticisms of restricted stock by adding performance conditions.

The key mission for boards of directors is to select the key goals that management and employees should strive to achieve, and then craft equity plans that attract and retain qualified personnel, spur achievement of those goals, and align the interests of employees with shareholders. The establishment and communication of those goals and the tailoring of equity awards to those goals are key. Absent thoughtful goals and linkage of the awards to the goals, neither restricted stock nor options are a panacea. This sentiment is supported and reiterated by the SEC staff in SAB 107.

Practical steps to consider now

Throughout this document, we have provided practical notes to readers about considerations to be aware of in planning for the adoption of Statement 123(R). The following represents a brief summary of those consideration plus some additional ideas:

What is required:

- Assess and test the adequacy of existing software programs/spreadsheets used in data collection and development of accounting entries.
- Choose an option pricing model and assumptions.
- Develop forfeiture assumptions.
- If the outstanding grants include awards with graded vesting, make a policy decision whether to use the straight-line method to accrue compensation in 2006 and future years.
- Choose a transition method.
- Disclose the impact of adopting Statement 123(R) on earnings and operating cash flows.
- Review the adequacy and accuracy of documentation and processes used to account for share-based compensation in conjunction with internal control reporting requirements.

What is voluntary:

- Consider pros and cons of existing share-based arrangements and other potential types of arrangements in conjunction with the company's goals for providing incentives to employees.
- Review the minutes of the meetings of the FASB Statement 123(R) Resource Group.
- Evaluate the need for systems upgrades or data on comparative companies as well as for utilization of third party service organizations for assistance in valuing share-based awards.
- Monitor the reactions of users of financial statements.
- Reevaluate key assumptions, such as volatility and expected term assumptions, prior to adoption of the standard, and exercise care in communicating any revisions.
- Assess impact on cash flows, financial covenants/ratios, etc.

Summary of Statement 123(R)'s Impact on Existing Literature and Additional Guidance Issued

Impact on Existing Literature

- Supersedes APB 25 and related interpretations (FIN 44, EITF 00-23, EITF Topic D-91, etc.)
- Amends Statement 123
- Amends Statement 95 (re: excess tax benefits)
- Does not change accounting for transactions with nonemployees (EITF 96-18 still applies)
- Does not change accounting for ESOP plans (AICPA Statement of Position 93-6 still applies)

Additional Guidance Issued

- FSP FAS 123(R) – 1 – Classification and Measurement of Freestanding Financial Instruments to follow guidance in FAS 123(R)
- FSP FAS 123(R) – 2 – Practical Accommodation to Application of Grant Date as Defined in FAS 123(R)
- FSP FAS 123(R) – 3 – Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards
- FSP FAS 123(R) – 4 – Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event
- Staff Accounting Bulletin No. 107
- FASB Statement 123(R) Resource Group Minutes

For More Information

If you would like further information or to discuss the implications of the matters discussed in this *Financial Reporting* letter, please contact the BDO Seidman engagement partner serving you or one of the following partners: Ben Neuhausen, Andy Gibson, or Jim Blinka.

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Material discussed in this Financial Reporting letter is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances.

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