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1•2•3(R)eady, Set, Go

Fair Value Accounting for Stock Options!

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Introduction

Just in time for your holiday enjoyment! On Thursday, December 16, 2004, the FASB issued Statement No. 123 (revised 2004), *Share-Based Payment*. Statement 123(R) requires all entities to recognize compensation expense[1] in an amount equal to the fair value of share-based payments (e.g., stock options and restricted stock) granted to employees.

As is our custom, we summarize the key concepts of the new standard in the body of *Heads Up*. For details, look to Appendix A. It includes an assortment of frequently asked questions, along with our interpretive responses. Notice to all readers — now is the time to refill, and perhaps spike, a big glass of eggnog.

Summary of Key Concepts

Scope

Statement 123(R) applies to **all** transactions involving the issuance, by a company, of its own equity (stock, stock options, or other equity instruments) in exchange for goods or services, including employee services. The key point — all stock option awards to employees will now hit the P&L as an expense, typically, over any related vesting period.

Statement 123(R) carried forward the guidance from Statement 123 for share-based payment transactions with non-employees. Therefore, the revised standard affects neither the accounting for share-based payment transactions with non-employees nor the accounting for employee stock ownership plans (ESOPs).[2] However, don't get too blasé. The FASB will reconsider ESOPs and non-employee transactions in a second phase of the equity-based compensation project. Until then, preparers should follow the non-employee guidance that has been carried forward in Statement 123(R) and Issue 96-18.[3]

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

[2] Existing ESOP guidance is contained in SOP 93-6.

[3] Titles of each Standard are referenced in Appendix D.

Effective Date

Statement 123(R) provides additional time for small business issuers (i.e., companies that have less than $25 million of revenue and meet certain other requirements) and nonpublic companies. The following table summarizes the required effective dates:

	The standard is effective for awards granted, modified, or settled after
Public companies (excluding small business issuers)	The first reporting period (**interim or annual**) beginning after June 15, 2005
Small business issuers	The first reporting period (**interim or annual**) beginning after December 15, 2005
Nonpublic companies	The first **annual** reporting period beginning after December 15, 2005

To illustrate, assume all of the following companies have calendar year-ends:

- A public company — adopt on July 1, 2005 (at the beginning of its third-quarter reporting period).
- A small business issuer — adopt on January 1, 2006 (at the beginning of its first-quarter reporting period).
- A nonpublic company — adopt on January 1, 2006 (at the beginning of its 2006 annual reporting period).

Itching to get started? While FASB encourages early adoption, companies may do so only if financial statements (annual or interim), for any period prior to the stipulated effective date, have not been issued. See Question 3 of Appendix A for a more detailed discussion of early adoption.

Transition

Public companies, including small business issuers, are **required** to apply this standard on a **modified prospective method**. Under this method, a company records compensation expense for all awards it grants after the date it adopts the standard. In addition, the company is required to record compensation expense (as previous awards continue to vest) for the unvested portion of previously granted awards that remain outstanding at the date of adoption. In addition, these companies **may elect** to adopt Statement 123(R) by restating previously issued financial statements, basing the amounts on the expense previously calculated and reported in their pro forma footnote disclosures that had been required by Statement 123 (this approach constitutes the **modified retrospective method**).

Thinking we forgot about nonpublic companies? See Question 2 in Appendix A for the transition guidance of nonpublic companies. Also, note that special transition provisions apply to awards that are classified outside of equity as liabilities (i.e., cash-settled stock appreciation rights). See Question 5 in Appendix A.

Measurement

In contrast to the long standing measurement objective of Opinion 25 (based on an option's intrinsic value), Statement 123(R) requires that companies use fair value to measure their share-based payment awards issued to employees. Fair value is computed at the date of grant, and, thereafter, (except for liability[4] awards) is **never** remeasured. Because subsequent remeasurement is prohibited, gone are the days of variable accounting.

How should fair value be computed? To start, if an observable market price exists for an option with the **same or similar terms**, companies should use that price. Unfortunately, these situations are rare. A typical market traded option has a much shorter term (usually not greater than three years) versus an employee-share option (with terms that can extend to ten years or more).

In the absence of an observable market price, companies must use a valuation technique based on established principals of financial economic theory. In the past, most companies have used the Black-Scholes-Merton formula for purposes of pro forma disclosures. Can companies continue to use the Black-Scholes-Merton formula under Statement 123(R)? The short answer to the question is yes — so long as the option pricing model a company uses encompasses all the pertinent factors of an award

4 Awards that call for settlement in cash or other assets of the company generally are considered liability awards. In addition, refer to Question 22 of Appendix A for a discussion of the interaction of this standard and Statement 150.

(e.g., volatility, expected terms, market conditions, etc.). See Questions 7–9 in Appendix A for further discussion of valuation techniques.

The same guidance applies to nonpublic companies, which should make every effort to value their share-based payment awards at fair value. However, the FASB acknowledges there may be instances when it is not reasonably practicable to estimate fair value. The expected volatility assumption is the biggest challenge since a nonpublic company's shares are not traded in a public market. In these cases, nonpublic companies may substitute the historical volatility of an appropriate industry sector index, in lieu of actual expected volatility. Does that mean a small cap, high-technology company should use the historical volatility associated with the S&P 500? **No**. The company should use the volatility associated with an index that is representative of its industry and its size. The FASB refers to the result as "calculated value" (versus "fair value").

Income Tax Accounting and Statement of Cash Flow Reporting

After receiving many objections to the income tax accounting proposed in the Exposure Draft, the FASB reverted to an approach already established in Statement 123. That is, companies record excess tax benefits as an increase (credit) to paid-in capital, never affecting the income statement (excess benefits arise when the actual tax deduction is greater than recorded book expense). Tax benefit deficiencies (book expense greater than the ultimate tax deduction) are recorded as a decrease (debit) to paid-in capital, again bypassing the income statement — but only to the extent previous excess tax benefits exist (often referred to as the "APIC pool"). The bad news? In the absence of an APIC pool, tax benefit deficiencies **must be** recorded as an expense in the income statement.

In connection with their conclusion reached on income taxes, the FASB re-affirmed the amendment to Statement 95 proposed in the Exposure Draft. As a result, companies are required to display (separate and apart from taxes paid) the impact of any excess tax deduction (over book expense). This "excess deduction" is reported **as a component of cash inflows from financing activities**. Actual taxes paid (an **operating cash outflow**) are increased by the same amount, resulting in a total that shows taxes that a company would have paid had it not been for the excess deduction. Sound confusing? See Question 14 in Appendix A for an illustration of the impact.

Modified Awards

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

Recognition of Compensation Expense

Compensation expense will be recognized over the requisite service period (almost always the same as the vesting period). However, the manner in which companies record compensation expense depends on the vesting schedule of an award. A company whose awards contain a cliff vesting schedule (e.g., 100 percent of the award vests after four years of service) records compensation expense straight-line (25 percent per year for four years). If an award contains a graded vesting schedule (e.g., 25 percent of the award vests at the end of each of four years of service), a company may record compensation expense **either** on a straight-line **or** an accelerated basis; the latter follows the guidance in Interpretation 28.

Here's one more change in the recognition of compensation expense. Previously, under Statement 123, companies were allowed **either** to estimate forfeitures on the date of grant, and adjust those earlier estimates when actual experiences differ from previous estimates, **or** recognize them as they actually occurred. Statement 123(R) **requires** companies to estimate forfeitures on the date of grant. In subsequent periods, companies will adjust their earlier estimates when information becomes available suggesting that actual forfeitures will differ. Companies that revise their forfeiture estimates would record the effects of the revision as a cumulative effect of a change in accounting estimate in the period in which the revision occurs. Keep in mind that a corresponding adjustment to any deferred tax asset is required for any change in forfeiture estimates.

Sounds too straight forward? This is only an overview of the basics (refer to Appendix B for a comprehensive example). The recognition requirements get more complex when vesting is linked to something other than the passage of time. See Questions 20 and 21 of Appendix A for discussion of more complex vesting terms.

Disclosure

The new statement beefs up the already hefty disclosure requirements for share-based payment arrangements. The revised disclosures are designed to enable users of financial information to understand (1) the general terms of a company's share-based payment arrangements, (2) the effects of share-based payment compensation on the income statement, (3) the method used to estimate fair value, and (4) the cash flow effects of share-based payment awards. See Appendix C for a detailed comparison of the existing disclosure requirements and those that are required under this standard.

Final Thoughts

Hungry for more? Listen to our *Share-Based Payment* webcast on Wednesday, January 5, 2005 at 2:00 PM (EST). If you have not done so already, please register for our Dbriefs webcast at www.deloitte.com/us. Worry not about your holiday budget. All Dbriefs webcasts are complimentary.

Appendix A
Questions and Answers Related to the Final Standard on Share-Based Payment

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Appendix A

Questions and Answers — Statement 123(R)

Note: While this appendix covers many significant topics, it is not intended to be a comprehensive discussion.

Effective Dates and Transition

1. When is Statement 123(R) effective?

This standard is effective for (1) public companies (excluding small business issuers) in **interim or annual** periods beginning after June 15, 2005, (2) small business issuers in **interim or annual** periods beginning after December 15, 2005, and (3) nonpublic companies in **annual** periods beginning after December 15, 2005. That is, public companies would adopt the standard on July 1, 2005, for their third-quarter reporting period; small business issuers on January 1, 2006, for their first-quarter reporting period; and nonpublic companies on January 1, 2006, for their annual reporting period — assuming that all of these companies have a calendar year-end.

2. What methods of transition are available to companies upon adoption?

At the date of adoption, all public and nonpublic companies that previously have used the fair-value based method of Statement 123 (either for recognition and measurement, or for disclosure)[5] must use the modified prospective method (for the period of adoption, and going forward). However, in dealing with prior reporting periods, companies may elect to restate prior periods using the modified retrospective method. Statement 123(R) describes the two methods as follows:

- The **modified prospective method** requires companies (1) to record compensation expense for the unvested portion of previously issued awards that remain outstanding at the initial date of adoption, **and** (2) to record compensation expense for any awards issued, modified, or settled after the effective date of this standard.
- The **modified retrospective method** allows companies to recognize, in their prior period financial statements, the **exact** amounts of compensation expense that previously were disclosed in pro forma footnote disclosures, as had been required by Statement 123. Companies choosing this method have additional flexibility (see below).

If a company uses the modified retrospective method and adopts the new standard during an interim period, it may elect to **either** apply the method for **all** prior periods for which Statement 123 had been effective **or only** for those prior interim periods in the initial year of adoption, if any. If a company elects the former, it will be required to record a cumulative effect adjustment to the beginning balance of paid-in capital, deferred taxes, and retained earnings. The statement precludes any change to the amounts originally disclosed in prior periods.

All other nonpublic companies, which used the minimum value method for recognition or disclosure purposes, **are required** to adopt the provisions of this standard **prospectively** for any newly issued, modified, or settled award after the date of initial adoption. Restatement of earlier periods is **not permitted**.

3. Will companies be able to early adopt the new standard?

As you might expect, Statement 123(R) permits and encourages early adoption, provided that financial statements (annual or interim) for the prior periods have not been issued. Upon adoption, companies would have the same transition methods discussed in Question 2 available to them. Said another way:

- Calendar year-end public companies could adopt as early as the fourth quarter of 2004, provided they have not issued their annual report on Form 10-K.
- Calendar year-end nonpublic companies could adopt as early as the year ended December 31, 2004, so long as their annual financial statements have not been issued.
- Alternatively, **any** calendar year-end company could adopt the new standard on January 1, 2005.

[5] This does not include nonpublic companies that adopted the provisions of Statement 123 using the minimum value method.

4. Will companies need to recalculate grant-date fair value for previously issued awards?

No. Under the modified prospective method, companies are **not allowed** to recalculate grant-date fair value for the unvested portion of previously issued awards that remain outstanding at the date of adoption. Compensation expense is based on the grant-date fair value as calculated previously and included in a company's prior period pro forma disclosures. Similarly, if companies elect to use the modified retrospective method, they are **precluded** from changing the compensation expense amounts that previously were disclosed in accordance with Statement 123's pro forma requirements.

5. What transition applies to liability awards (e.g., cash settled stock appreciation rights) that had been accounted for at intrinsic value?

For these awards, all public companies (and nonpublic entities that elect to account for their liability awards at fair value) must record an adjustment for the cumulative effect of change in accounting principle. The adjustment is computed as the difference between the amount currently recorded as a liability (i.e., intrinsic value) and the fair value of the award on the date of initial adoption (included in the adjustment are any related tax effects). See Question 11 for further discussion of liability awards.

6. What is the financial statement impact if a company elects, prior to the adoption of Statement 123(R), to accelerate vesting of currently outstanding "out-of-the money" awards?

Once adopted, Statement 123(R) generally treats the acceleration of vesting of "out-of-the-money" options as a non-substantive modification. If so considered, an entity will be required to continue recording compensation expense for the award, usually over the original vesting period. This prevents entities from accelerating vesting, when options have little current value, simply to "get the expense behind you."

The FASB considered adding a transition provision to Statement 123(R) that would have required a similar analysis for awards that had been modified prior to adoption. However, the Board has concluded otherwise, and entities should continue to account for the modification following the guidance of Opinion 25 (and Interpretation 44), or Statement 123. These awards would be subject to the transition provisions for fully vested awards. See Question 2 for a discussion of transition.

> **Editor's Note:** Public companies should consider carefully the remarks made by Scott A. Taub, *Deputy Chief Accountant*, Office of the Chief Accountant, at the 2004 AICPA National Conference on Current SEC and PCAOB Developments regarding the structuring of transactions around accounting standards. Mr. Taub indicated that companies should be prepared to disclose, to the investing community, the terms of the modification and its business purpose. More specifically, refer to the remarks made by Chad A. Kokenge, *Professional Accounting Fellow*, Office of the Chief Accountant, regarding the acceleration of vesting prior to the adoption of Statement 123(R). For further discussion of the remarks made by Mr. Taub, Mr. Kokenge, and other members of the SEC staff, refer to our *Heads Up* dated December 13, 2004.

Measurement

7. Absent an observable market price, what valuation technique must be used to calculate fair value?

Statement 123(R) does not prescribe the use of any particular valuation technique. It broadly describes fair value as the amount at which market participants would be willing to conduct transactions. As long as the valuation technique (1) is consistent with the fair value measurement objective, and (2) is capable of incorporating all of the substantive characteristics unique to employee stock options (e.g., market conditions, restrictions after the vesting period, etc.), a company may use a closed form (Black-Scholes-Merton) or an open form (lattice) model.

8. What are the minimum factors a company must consider in estimating the fair value of their share-based payment awards?

At a minimum, and regardless of the valuation technique it uses, a company must incorporate the following items into its estimates of fair value: (1) the exercise price of the award, (2) the expected term of the award, (3) the current price of the underlying share, (4) the expected volatility of the price of the underlying share, (5) the expected dividends on the underlying share, and (6) the risk-free interest rate. Note that the expected term includes the contractual term of the award after consideration of the effect on the term by employees' expected exercise and post-termination behavior.

9. What are the similarities and differences between the main valuation techniques in use today?

Both the Black-Scholes-Merton formula and the binomial (lattice) model require companies to use the same model inputs. The key difference? The Black-Scholes-Merton formula only allows for static inputs, whereas, the lattice model allows companies to incorporate estimated variability of inputs during the term of the award. For example, a lattice model permits companies to vary the expected term of the award depending on the employees' exercise and post-vesting termination behavior. The lattice model also allows companies to vary the volatility of the underlying stock and the dividend yield, as changes in these factors are expected to occur.

10. Do different requirements for valuing share-based payment awards apply to public and nonpublic companies?

Not conceptually. Both public and nonpublic companies are **required** to value their share-based payment awards at fair value on the date of grant. However, there may be instances in which it is not reasonably practicable for a nonpublic company to estimate the expected volatility[6] of its own share price. In those situations, a nonpublic company can substitute the historical volatility of an **appropriate** industry sector index, instead of the expected volatility of its own share price, into the valuation model. The result is what the FASB is calling this "calculated value" versus "fair value." This permitted deviation from fair value is not available to public companies.

11. How will share-based payment awards recorded as liabilities be measured?

Each reporting period, public companies should remeasure their liability awards at fair value until the date of settlement. In contrast, Statement 123 required companies to remeasure their liability awards at intrinsic value.

Nonpublic companies are required to make a one-time policy election to record their liability awards at fair value or at intrinsic value. In either case, the awards would be remeasured each reporting period until settlement.

Example

Assume a public company issued a cash-settled stock appreciation right on January 1, 2006, with a fair value on the date of grant of $20 and a four-year service period. On December 31, 2006 and 2007, the award has a fair value of $30 and $25, respectively. The company would record the liability award at fair value each reporting period. On December 31, 2006, the company records $7.50 ($30 × 25% vested = $7.50) of compensation expense with a corresponding recognition of a share-based liability. On December 31, 2007, the company records an additional $5 (($25 × 50% vested) – $7.50 = $5) of compensation expense with a corresponding increase to share-based liability.

12. What is the accounting for an Employee Share Purchase Plan (ESPP) that qualifies as noncompensatory under Section 423 of the IRS Code?

In a change from the Exposure Draft, an ESPP is **not considered compensatory** as long as it meets all of the following criteria:

- The terms of the plan are no more favorable than those available to all holders of that same class of equity, **or** the plan allows a discount from market that is not greater than the brokerage cost of offering equity securities to the public;[7]
- Includes substantially all full-time employees; and
- The plan does not incorporate any look-back feature.

Contain your enthusiasm. Most current Section 423 plans fail one or more of the above conditions.

[6] As described in Question 8, expected volatility is one of the minimum factors that should be input into a valuation model in order to derive a share-based payment award's fair value.

[7] The Board considers a five percent or less discount from the market a safe harbor for determining this amount. An amount greater than five percent would require further justification.

Income Tax Accounting

13. How does a company recognize income taxes for share-based payment awards?

The statement requires companies to account for income taxes in a manner similar to the one prescribed in Statement 123. That is, companies record excess tax benefits as an increase (credit) to paid-in capital, never affecting the income statement (excess benefits arise when the actual ultimate tax deduction is greater than recorded book expense). Tax benefit deficiencies (the book expense is greater than the ultimate tax deduction) are recorded as a decrease (debit) to paid-in capital, again bypassing the income statement — but only to the extent previous excess tax benefits exist (often referred to as the "APIC pool"). In the absence of an APIC pool, tax benefit deficiencies **must be** recorded as an expense in the income statement.

Example

Assume a company grants non-qualified stock options to its employees with a grant-date fair value of $1 million and a four-year service period. As the $1 million of compensation expense is recognized over the service period, the company records a deferred tax asset, in accordance with Statement 109, equal to the book compensation expense multiplied by the corporation's combined statutory tax rate. Why? The company is recording compensation expense for financial statement purposes that does not yet represent a current deductible item for tax purposes.

If the tax deduction[8] on exercise is greater than the $1 million of compensation expense, the deferred tax asset is reversed in full, and the excess benefit is credited to equity. If the tax deduction is less than the $1 million of compensation expense, the deferred tax asset likewise is reversed; however, the recognition of the difference (i.e., the amount of the deferred tax asset in excess of the tax benefit) will depend on the existence of an APIC pool. If a sufficient APIC pool exists, the shortfall is recorded as a reduction to equity. On the other hand, if the APIC pool is insufficient, the shortfall is recorded as an increase to current period income tax expense.

14. How does Statement 123(R) change the presentation of the statement of cash flows?

Companies are required to separately identify excess tax benefits (see Question 13) as **operating** cash outflows. Companies record this same amount as **cash inflows from financing activities**, representing the amount of cash the company was able to retain as a result of these excess tax benefits.

However, if a company realizes a tax-benefit deficiency, it makes no adjustment to the statement of cash flows.

Example

Assume a company issues 100 non-qualified stock options to an employee with a grant-date fair value of $10 per option (total fair value of $1,000, or 100 options x $10). Further, assume that the stock price at the grant date is $30, as is the exercise price of each option. The company's effective tax rate is 40 percent. As a result, the company will record a $400 tax benefit and a related deferred tax asset, for financial reporting purposes, over the life of the award.

Four years later, the employee exercises all 100 options. On the date of exercise, the company's common stock has a fair value of $42 per share. Under current U.S. income tax law, the company will receive a tax **deduction** based upon the difference between the fair value of the stock on the exercise date and the amount the employee pays to exercise. ($1,200 = ($42 – $30) × 100 options). As a result of the increase in the company's share price, the company realizes a tax benefit of $480 ($480 = $1,200 deduction × 40 percent tax rate) for income tax purposes. The $480 tax benefit exceeds the tax benefit recognized for book purposes by $80 (which will be recorded directly to equity), and represents the excess deduction discussed in the following paragraph.

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

Example (continued)

Also, assume that in the year of exercise, the company has taxable income in the amount of $2,100 (prior to considering the impact of the $1,200 stock compensation deduction) or $900 of taxable income after the stock compensation deduction. The company pays tax of $360 ($900 taxable income × 40% = $360). In accordance with Statement 95, the $360 of taxes paid is reflected as an operating cash outflow. However, absent the excess deduction, the company would have paid an additional $80 (($1,200 tax deduction – $1,000 compensation expense) × 40% = $80) of taxes. The amount of taxes the entity would have paid in the absence of an excess deduction ($80) should be shown as an additional cash outflow from operations, and a corresponding cash inflow from financing activities.

Modified Awards

15. What is the accounting for modifications of share-based payment awards?

Companies are required to record the incremental fair value of the share-based payment award as compensation expense on the date of modification, or over the remaining service period (for unvested awards). The incremental expense is the excess of the fair value of the modified award on the date of modification over the fair value of the original award immediately before the modification.

16. What is the accounting for re-pricings of share-based awards?

Unlike the existing Opinion 25 requirement to account for awards as variable after a re-pricing, Statement 123(R) considers re-pricings to be a modification of an award. Therefore, a re-pricing is accounted for as described in Question 15.

17. What is the accounting for a share-based award that is converted from a liability into equity (and vice versa)?

Assume an award previously has been classified as a liability. Because of a modification (e.g., a cash-settled stock appreciation right is modified to a share-settled stock appreciation right), the award now qualifies for equity classification. On the date of modification, the amounts previously recorded as a share-based liability should be recorded as a component of equity (additional paid-in capital). The aggregate amount of compensation expense should be the fair value of the award on the date of modification (i.e., the grant date of the equity award).

Example

Assume a company issued a cash-settled stock appreciation right (SAR) on January 1, 2006 with a grant date fair value of $30 and a four-year service period. On December 31, 2007, the company modifies the award from a cash-settled SAR to a share-settled SAR. The fair value on the date of modification is $25.

On December 31, 2007, the modified award would be accounted for as an equity award from the date of modification with a fair value of $25. As a result, the company reclassifies the amount previously recorded as a share-based liability ($12.50 = $25 × 50% vested) to additional paid-in capital. In addition, the company records the remaining $12.50 of modified fair value over the remaining service period.

This differs from the accounting for an award that was classified as an equity award and is later modified to a liability. For those modifications, a company would recognize a share-based liability for the portion of the award related to prior service, multiplied by the modified award's fair value. If the fair value of the modified award is less than or equal to the fair value of the original award, then the offsetting amount is recorded to additional paid-in capital (i.e., final compensation expense can not be less than grant-date fair value). If, on the other hand, the fair value of the modified award is greater than the fair value of the original award, then the excess is recognized as compensation expense. Because the award is now classified as a liability, it is remeasured at fair value each reporting period. See Question 11.

Example

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

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

Alternatively, assume the fair value on the date of modification is $25. The company would reclassify the portion of the award's modified fair value $12.50 ($25 × 50% vested) currently residing in additional paid-in capital as a share-based liability.

Because the award is now a liability award, the company is required to remeasure it each reporting period. If the value of the liability award, at settlement, is less than its grant-date fair value, then total compensation expense will equal grant-date fair value, with a portion of that value remaining in equity. On the other hand, if at settlement, the value of the liability award is greater than its grant-date fair value, total compensation expense will equal the liability award's value at settlement. This accords with the Statement's requirement that compensation expense should be recorded, at a minimum, at its grant-date fair value.

Recognition of Compensation Expense

18. Does Statement 123(R) change the manner in which compensation expense is attributed?

Yes. For pro forma disclosure purposes, you may recall that Statement 123 **required** companies to follow an Interpretation 28 accelerated recognition approach for awards with graded vesting,[9] in which each vesting period was valued as a separate award.[10] Statement 123(R) provides more flexibility. Companies are allowed to make an accounting policy decision for awards with graded vesting. They can record compensation expense either on a straight-line or an accelerated basis (Interpretation 28 model) over the service period. **Note:** Awards with cliff vesting (e.g., 100 percent of the award vests after four years of service) continue to accrue compensation expense on a straight-line basis over the service period.

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

No. Previously recognized compensation expense cannot be reversed for a **vested** award that expires unexercised.

20. How does a performance condition (e.g., an award that vests only if the company achieves a specified net income target or revenue target) impact the amount of compensation expense recognized?

A performance condition is defined as a condition affecting the vesting of an award that relates to achieving a specified performance target, based on a company's own operations. An example is an award that vests only if the company achieves cumulative revenue greater than $1 billion over the three-year period following the grant.

Statement 123(R) indicates that performance conditions should **not** be a factor in determining grant-date fair value of an award. However, because failure to achieve the performance condition precludes vesting of the award, a company records **no** compensation expense if the performance condition is **not met**. This comports with the statement's general premise that compensation expense should be recorded only for awards that eventually vest; no compensation expense should be recorded for awards where a performance condition is not achieved because that award never vests.

[9] What is meant by a graded vesting award? A graded vesting award is, for example, an award in which 25 percent of the award vests each year for four years. This is in contrast to a cliff vesting award, in which 100 percent of the award vests at the end of the fourth year.

[10] Assume an award consists of 100 options and the holder vests ratably over each of the next four years. Under the Interpretation 28 model, approximately 52 percent of total compensation expense is recognized in the first year (e.g., (100% × 25) + (50% × 25) + (33.3% × 25) + (25% × 25)).

21. How does a market condition (e.g., an award that only vests, or becomes exercisable, if the company's stock price reaches a specified target) impact the amount of compensation expense recognized?

Market conditions usually are linked to a company's share price, or to a market index. For example, an employee will receive and vest in 1,000 share options, if, and when, the company's share price closes at a price greater than or equal to $15 per share. Unlike a performance condition that affects the vesting of an award, Statement 123(R) concludes that a market condition that impacts vesting or exercisability should be factored into the grant-date fair value of an award. The fact that the holder's ability to exercise the award is contingent upon a market condition, reduces the fair value of the award compared to a similar award that does not contain a market contingency. Since the impact of the market condition is factored into the fair value of the award at the grant date, a company must recognize compensation expense for these awards, so long as the employee provides the "requisite service" to the company. In short, the company **is required** to record compensation expense **regardless** of whether the market condition is ever **met**, and whether the award ever became exercisable.

22. How does Statement 123(R) interact with the provisions of Statement 150?

Generally, an instrument considered a liability under the provisions of Statement 150 (or under Issue 90-19) also is considered a liability under the provisions of Statement 123(R). In other words, while Statement 150 scopes out employee stock compensation, Statement 123(R) requires that if an instrument would be classified as a liability under Statement 150, then the instrument is likewise a liability for Statement 123(R) purposes. A word of caution — certain instruments considered liabilities under Statement 123(R) **may not** meet the definition of a liability under Statement 150 (and the related guidance in Issue 90-19). Statement 123(R) requires an entity to consider its prior settlement history of equity awards (for example, a history of cash settlement of stock options) in determining whether the award represents, in substance, a liability. In contrast, Statement 150 and Issue 90-19 focus on whether a company has a contractual choice of settling in stock or cash, without consideration of past practice or intentions.

Disclosure

23. What additional financial statement footnote disclosures are required?

Companies must provide significantly more financial statement footnote disclosures compared to current U.S. GAAP requirements. The more significant additions include: (1) a tabular reconciliation of nonvested awards, (2) unrecognized compensation expense related to nonvested awards, (3) cash used to settle share-based awards, (4) cash received in connection with share option exercises, and (5) employees affected by, and incremental expense related to, award modifications. Refer to Appendix B for a detailed comparison of the disclosure requirements of pre-existing standards and the new standard.

24. What are the disclosure requirements for companies that issue share-based payment awards under multiple arrangements?

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

25. Do companies still have to provide Statement 123 pro forma disclosures for share-based awards in prior periods?

Yes. For all periods in which an income statement is presented that includes awards accounted for under the provisions of Opinion 25, public companies need to provide the pro forma information required by Statement 123 (as amended by Statement 148). However, companies that elect to apply the modified retrospective method for all periods presented are not required to provide this information. Companies that elect to apply the modified retrospective method for only the prior interim periods of the initial year of adoption are required to provide the pro forma disclosures for the prior annual periods presented.

Nonpublic companies that used the minimum value method for their pro forma disclosure requirements under Statement 123 are **not allowed** to continue providing those disclosures under this standard for any outstanding awards that are accounted for under the intrinsic value method of Opinion 25.

Appendix B
Comprehensive Example

Assume a calendar year-end company issues one million employee stock options on January 1, 2006 with a strike price of $25, grant-date fair value of $10, and a four-year cliff vesting requirement. The company expects five percent of its workforce to terminate employment voluntarily before the awards fully vest. The company's combined statutory tax rate is 40 percent.

Based on current assumptions in each of the four years, the company accrues compensation expense of $2,375,000 based on (1) the total number of awards expected to vest (950,000 = 1 million x (100% – 5% forfeitures)), (2) the grant-date fair value of the awards ($10), and (3) the services rendered (25%). Don't forget about the tax consequence. The company records an income tax benefit and a corresponding deferred tax asset, in accordance with Statement 109, equal to the book compensation expense ($2,375,000), multiplied by the company combined statutory tax rate (40%). Refer below for annual journal entries.

	Debit	Credit
2006		
Compensation expense	$2,375,000	
Additional paid-in capital		$2,375,000
Deferred tax asset	950,000	
Income tax expense		950,000
2007		
Compensation expense	2,375,000	
Additional paid-in capital		2,375,000
Deferred tax asset	950,000	
Income tax expense		950,000

On December 31, 2008, the company revises its estimate of the number of expected forfeitures to ten percent (to reflect a change in the company's best estimate). As a result, the company must adjust the cumulative amount of compensation expense recorded to date as a component of current period compensation. For the year ended December 31, 2008, the company bases its amount of compensation expense on 900,000 (1,000,000 × (100% – 10%)) awards expected to vest. Under the revised estimate, as of December 31, 2008, the company should have recorded cumulative compensation expense of $6,750,000 (900,000 × $10 × 75% of services rendered) and a corresponding income tax benefit of $2,700,000 ($6,750,000 × 40%).

Since the company has recognized previously $4,750,000 of compensation expense and $1,900,000 of income tax benefit, it would record an additional $2,000,000 of compensation expense and $800,000 of income tax benefit in 2008. Assume no further revisions to the forfeiture estimate were made, and 900,000 awards became vested in 2009. Refer to journal entries below.

	Debit	Credit
2008		
Compensation expense	$2,000,000	
Additional paid-in capital		$2,000,000
Deferred tax asset	800,000	
Income tax benefit		800,000
2009		
Compensation expense	2,250,000	
Additional paid-in capital		2,250,000
Deferred tax asset	900,000	
Income tax benefit		900,000

Finally, assume that on July 1, 2010, 450,000 of the awards are exercised (stock price on the date of exercise is $50). Because the stock price results in a tax deduction ($11,250,000 = $25 intrinsic value × 450,000) in excess of the compensation expense recognized for book purposes ($4,500,000 = 450,000 × $10 fair value), the company will record an additional tax benefit, as a component of equity, calculated as follows:

Benefit for tax purposes	$ 4,500,000
Benefit for book purposes	(1,800,000)
Excess tax benefit	$ 2,700,000

Benefit for tax purposes	=	$11,250,000 tax deduction multiplied by the company's statutory tax rate (40%).
Benefit for book purposes	=	Compensation expense recognized for book purposes ($4,500,000) multiplied by the company's statutory tax rate (40%).

The recognition of the excess tax benefit corresponds with the reversal of the appropriate deferred tax assets. **Note:** As only one-half of the vested awards were exercised, only half of the deferred tax assets should be reversed. Refer to journal entry below.

	Debit	Credit
2010		
Income tax receivable/payable	$4,500,000	
Deferred tax asset		$1,800,000
Additional paid-in capital		2,700,000

Appendix C

Disclosure Requirements of the Final Standard on Share-Based Payment

The following compares existing disclosure requirements to those required by Statement 123(R). Changes have been highlighted in bold text.

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

Existing Disclosure Requirements	Disclosures Under New Standard
Not Required	**For fully vested share options (or stock units) and share options expected to vest as of the date of the latest statement of financial position, provide the following information for awards outstanding and currently exercisable (or convertible):** **a. Number** **b. Weighted-average exercise price (or conversion ratio)** **c. Aggregate intrinsic value** **d. Weighted-average remaining contractual term of options (or share units)**
For each year an income statement is presented, provide: a. A description of the method and the significant assumption used to estimate fair value, including: i. Risk-free interest rate ii. Expected life iii. Expected volatility iv. Expected dividends	For each year an income statement is presented, provide: a. A description of the method, and the significant assumption used, to estimate fair value (or calculated value) of share-based compensation awards, including: i. Risk-free interest rate ii. Expected term, **including method used to incorporate contractual life and expected exercise, and termination behaviors** iii. Expected volatility **and method used to estimate it (nonpublic companies using calculated value should disclose reasons why it is not practicable to estimate its own volatility, the index used, the reasons for selecting that index, and how it calculated historical volatility of that index)** iv. Expected dividends **v. Discount for post-vesting restrictions and the method for estimating it**
For each year an income statement is presented, provide: a. Compensation cost recognized in income b. The terms of significant modifications of outstanding awards	For each year an income statement is presented, provide: a. Compensation cost recognized in income, **including the income tax benefit** **b. Compensation cost capitalized as part of the cost of an asset** c. A description of significant modifications, including the terms, **the number of employees affected, and the total incremental compensation cost**
Not Required	**As of the latest balance sheet date presented, the compensation cost related to nonvested awards not yet recognized, and the weighted-average period over which compensation is expected to be recognized**

Existing Disclosure Requirements	Disclosures Under New Standard
Not Required	**If not disclosed elsewhere, the amount of cash received from exercise of share options, and similar instruments, granted under share-based arrangements, including the tax benefit realized**
Not Required	**The amount of cash used to settle equity instruments granted under share-based payment arrangements**
Not Required	**A description of the entity's policy, if any, for issuing shares upon share option exercises (or share unit conversion), including the source of those shares (e.g., new or treasury). If, as a result of policy, the entity expects to repurchase shares in following annual period, disclose an estimate or range of shares to be repurchased**

Appendix D
Glossary of Standards

FASB Statement No. 95, *Statement of Cash Flows*

FASB Statement No. 109, *Accounting for Income Taxes*

FASB Statement No. 123, *Accounting for Stock-Based Compensation*

FASB Statement No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure*

FASB Statement No. 150, *Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity*

FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*, *an Interpretation of APB Opinions No. 15 and 25*

FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*

APB Opinion No. 25, *Accounting for Stock Issued to Employees*

EITF Issue No. 90-19, "Convertible Bonds With Issuer Option to Settle for Cash Upon Conversion"

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"

AICPA Statement of Position 93-6, *Employer's Accounting for Employee Stock Ownership Plans*

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