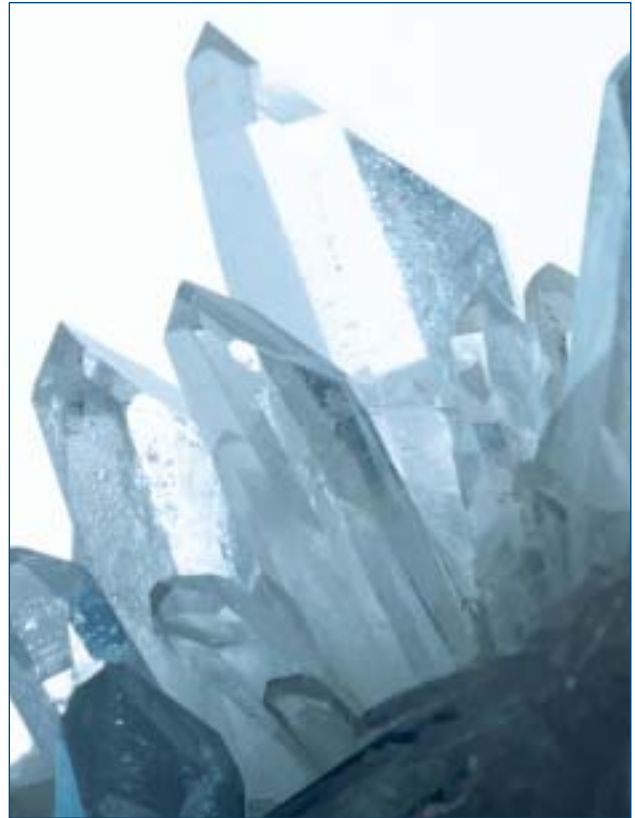


defining issues®

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Expensing Stock Options Gets Crystallized

The FASB formally proposed to require companies to recognize the fair value of stock options and other stock-based compensation to employees for 2005 reporting periods, a policy consistent with the related international standard released last month and with convergence between the two sets of standards.¹ The questions more in play at this point are how “share based payments” (to use the IASB term adopted by the FASB) should be valued and classified and the related implementation difficulties. Comments on the exposure draft are due by June 30, 2004.

This edition of *Defining Issues* summarizes the exposure draft’s major provisions, highlights implementation issues, and identifies differences between the exposure draft and the new international standard called IFRS 2.

SCOPE

The exposure draft addresses only accounting for share-based awards to employees, including employee-stock-purchase-plans (ESPPs). Accounting for employee-stock-ownership-plan transactions (ESOPs) and awards to nonemployees will be taken up in a later phase of the project.²

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(1) FASB Exposure Draft, Share-Based Payment: an amendment of FASB Statements No. 123 and 95, March 31, 2004, available at www.fasb.org. International Financial Reporting Standard 2, Share-Based Payment, February 2004.

(2) ESOPs would continue to be accounted for under the provisions of AICPA Statement of Position No. 93-6, Employers' Accounting for Employee Stock Ownership Plans, November 1993. Awards to nonemployees would continue to be accounted for under FASB Statement No. 123, Accounting for Stock-Based Compensation, October 1995.

ESPPs are compensatory under the exposure draft unless the terms of the employee plan are the same as those available to all shareholders of the same class of equity and substantially all eligible employees may participate on an equitable basis. We expect these criteria to be difficult to meet. More ESPPs would be treated as compensatory than is the case under Statement 123 or APB 25.³

CLASSIFYING AWARDS AS LIABILITIES OR EQUITY

Many awards with cash-based settlement or repurchase features, such as a stock appreciation right with a cash-settlement option, would be liability-classified awards, as would be awards for a fixed dollar amount settleable in the company's stock. Share-based awards with net-settlement features for minimum-tax withholdings would continue to be equity-classified awards under the exposure draft. Similarly, awards that permit a cashless exercise using a broker unrelated to the employer generally would continue to be equity-classified awards.

Liability-classified awards would be remeasured each period at fair value. Equity-classified awards would not be remeasured after the grant date.

MEASURING COMPENSATION COST

The measurement objective is to estimate, as of the grant date, the fair value of an award that an employee earns by having rendered the requisite service and satisfied other required conditions for the award to vest. The estimate of fair value would reflect transferability and other restrictions only if they are in effect after the award vests. For example, a restriction that includes a two-year prohibition on the sale of stock received from exercising options would be incorporated into the valuation of the award. Service and performance vesting conditions would not affect an award's fair value. They would be reflected by recognizing compensation cost only for awards that vest.

Valuation Models. In the absence of an observable market price for an award, as is the case for most employee share options, companies would be required to use a valuation method that independent parties would use to value the award. The FASB believes that independent parties would likely use a lattice model (e.g., a binomial model) to value share options because it can accommodate more potential post-vesting behaviors than

can a closed-form model (e.g., a Black-Scholes model). For that reason, the exposure draft states that the use of a lattice model to value share options is preferable to a closed-form model. However, because some companies may be unable to obtain reliable data to populate the lattice model, the exposure draft would allow companies to use a closed-form model that provides a reasonable estimate if it is impracticable to obtain sufficiently reliable data needed to apply a lattice model.

Lattice models value options by constructing lattices or trees that represent possible future stock prices at different points in time, from which the value of the option at each node or branch of the tree can be established. To populate the "lattices" companies will need information about volatility, dividends, and risk-free rates for each different node, both over time and within a given time period. They will also need to develop information about employees' post-vesting behaviors, such as early exercise as the stock price increases (referred to as suboptimal exercise) and post-vesting termination patterns. Closed-form models, on the other hand, permit only a single set of inputs and are limited in the number of factors they consider.

Employee post-vesting behaviors, such as how quickly or slowly an employee exercises a vested award in relation to its contractual maturity, depend upon many factors, including changes in the market price of the underlying stock. An employee with vested options would not exercise them if they were underwater even if facing termination, so the termination would result in nonexercise. However, an employee with a vested award that permits exercise for a short period of time after termination would likely exercise an in-the-money option after termination. These possible outcomes affect the value of an award.

It is unclear at this time how companies would obtain, accumulate, and analyze the inputs for employee-behavior needed to populate the lattices. We believe that many companies do not now retain comprehensive information about employee exercise behaviors in the way that would be required to apply a lattice model in accordance with the proposed requirements. Many companies might be able to develop this information from their historical experience, but at a cost.

Equity-Classified Awards. Equity-classified awards that have observable market prices (e.g., if they are publicly traded)

(3) APB Opinion No. 25, Accounting for Stock Issued to Employees, October 1972.

would be valued at that market price. Otherwise they would have to be valued using a valuation model. Since an equity-classified award's valuation does not reflect restrictions that are in effect during the vesting period, a nonvested stock grant would be valued at the market price of the stock on the date of grant, as would a vested stock grant.

Liability-Classified Awards. Public companies' liability-classified awards would be remeasured at fair value each reporting period. Prior to vesting, cumulative compensation cost would equal the proportionate amount of the award earned to date. Subsequent to vesting, the entire change in fair value would be recorded in earnings. This differs from current requirements under which liability-classified awards are measured at intrinsic value.

Because liability-classified awards would have to be remeasured each reporting period (as opposed to equity-classified awards, which would be measured only at grant date), they would add variability to earnings.

Valuation for Graded-Vesting Awards. Companies that grant awards with graded vesting would no longer be permitted to measure the award as though it were a cliff-vested award. A graded-vesting award might vest, for example, 25 percent at the end of each year over four years. These awards would have to be treated as four separate awards, and companies would be required to build a separate lattice model for each tranche to estimate its fair value. Each tranche would have its own set of inputs about volatility, dividend rate, risk-free rate, employee exercise behavior, and post-vesting terminations.

Measurement Alternative for Nonpublic Companies. Nonpublic companies would be required to make an accounting policy decision to measure share-option and liability-classified awards either at their fair value or at their intrinsic value (the amount by which the underlying stock's market price exceeds the award's exercise price). No such election is available for nonvested or vested stock awards, such as restricted stock, which would be measured using grant-date fair value. Under the intrinsic-value alternative, the intrinsic value of an equity-classified award would be estimated each reporting period, whereas under the fair-value policy alternative, an equity-classified award would not be remeasured subsequent to the grant date. For this reason, the intrinsic-value alternative would cause greater fluctuations in earnings for equity-classified awards than would the fair-value policy

alternative. Statement 123's minimum-value method for measuring fair value, which omits volatility, would no longer be permissible.

The measurement basis of equity- or liability-classified awards granted to employees of nonpublic companies would be a one-time accounting policy decision. Since the fair-value method is preferable, nonpublic companies would be able to justify only a change from the intrinsic-value method to the fair-value method after the initial policy election.

RECOGNIZING COMPENSATION

Vesting can be based on a service condition, a performance condition, or a combination of both. A service condition is a requirement to achieve a specified duration of employment (e.g., an award vests after two years of service). A performance condition is a requirement to achieve a company-specific operating or financial goal (e.g., an award vests after three years of service if the company's average EPS for the next three years is \$4.00).

Compensation cost would be recognized based on the number of awards that eventually vest. The amount accrued each period until the vesting date would be based on the estimated number of awards that are expected to vest. The estimate would be adjusted up or down each period to reflect the current estimate of forfeitures, and, finally, the actual number of awards that vest. This differs from Statement 123's provisions, which permit companies to use either this estimated approach or to recognize compensation cost by assuming all awards will vest, adjusting for actual forfeitures as they occur.

A market condition affects the exercisability of an award, not its vesting, according to the exposure draft. It defines a market condition as an exercisability requirement based on achieving a specified measure of the company's share price (e.g., an award becomes exercisable if, during the next two years, the closing price of the company's stock is above \$80 per share for 30 consecutive trading days). If an award's exercisability depends on achieving a market condition, recognized compensation expense would not be reversed for awards that meet a service or performance condition and are therefore vested (i.e., the service has been rendered). However, market conditions, as defined by the exposure draft, can affect the related award's grant-date fair value. The effects on compensation expense from service, performance, and market conditions are illustrated in the following example.

COMPENSATION EXPENSE UNDER DIFFERENT VESTING CONDITIONS

Company A grants 10,000 equity-classified awards (e.g., share options) to employees. The grant-date fair value is determined to be \$6 per equity-classified award.

Case 1—All awards cliff-vest after three years of service. Company A originally estimates that 94% of the award recipients will remain employed for the entire three years. At the beginning of Year 3, based on its current experience, Company A revises its estimate of forfeitures and now expects 91% of the award recipients to remain employed for the entire three years.

Case 2—Assume the same information from Case 1 except that prior to the end of Year 3, 45% of the award recipients leave the Company and thereby forfeit their awards.

Case 3—Assume the same facts from Case 1. Additionally, awards become exercisable only if during the three-year service period, Company A's stock price outperforms the S&P 500 index by 10 percent (a market condition). Company A's forfeiture experience is the same as Case 1 (91% of the award-recipients were employed for the three-year period). At the end of the three-year period, Company A's stock price has outperformed the S&P 500 index by only 3 percent. Therefore, no awards are exercisable. The compensation expense recognized in Case 3 would not be reversed, because 91% of the awards vested (the service condition was met), even though the vested awards are not exercisable because the market condition was not met.

Case 1

	Year 1	Year 2	Year 3
Total value			
Number of awards	10,000	10,000	10,000
Fair value per award	\$ 6	\$ 6	\$ 6
	\$ 60,000	\$ 60,000	\$ 60,000
Percentage expected to vest	94%	94%	91%
	\$ 56,400	\$ 56,400	\$ 54,600
Proportion of service period completed at year-end	1/3	2/3	3/3
Cumulative expense recognized at year-end	\$ 18,800	\$ 37,600	\$ 54,600
Cumulative expense previously recognized	—	\$ 18,800	\$ 37,600
Current period expense	\$ 18,800	\$ 18,800	\$ 17,000

Case 2

	Year 1	Year 2	Year 3
Total value			
Number of awards	10,000	10,000	10,000
Fair value per award	\$ 6	\$ 6	\$ 6
	\$ 60,000	\$ 60,000	\$ 60,000
Percentage expected to vest	94%	94%	55%
	\$ 56,400	\$ 56,400	\$ 33,000
Proportion of service period completed at year-end	1/3	2/3	3/3
Cumulative expense recognized at year-end	\$ 18,800	\$ 37,600	\$ 33,000
Cumulative expense previously recognized	—	\$ 18,800	\$ 37,600
Current period expense/(income)	\$ 18,800	\$ 18,800	\$ (4,600)

MODIFIED AWARDS

Modifications of awards include repricing, extending the life, or changing the vesting condition of an award. The exposure draft would require different accounting treatments for modifications depending on the likelihood of vesting at the date of the modification based on the award's original terms. If, at the

date of the modification, it is not probable that the original award would have vested, the cumulative compensation to be recognized would be the value of the modified award. If, at the date of the modification, it is probable that the original award would have vested, the cumulative compensation to be recognized would equal the grant-date fair value of the original award plus the incremental value of the modified award.

For example, assume that Company B grants 20,000 equity-classified awards with an exercise price of \$10 per award in Year 1 with a fair value per award of \$5 (total fair value is \$100,000). The awards cliff vest after four years of service, and all award recipients remain employed throughout that period. In Year 3, because its stock price has declined significantly, Company B decides to reduce the exercise price of the awards to \$3, which equals the current price of the stock. The modified awards maintain the original vesting terms and have a fair value of \$1.20 per award. The original awards had a fair value of \$.75 immediately before the modification (with an exercise price of \$10, they were deeply out-of-the money). Based on this information, Company B would recognize compensation expense of \$25,000 in each of Years 1 and 2 (\$100,000 value of original award divided by the four-year service period). At the end of Year 2, unrecognized compensation cost on the original awards equals \$50,000. In each of Years 3 and 4, Company B would recognize compensation expense of \$29,500 calculated as the amount from the original award (\$25,000) plus the incremental amount from the modification (the product of 20,000 x \$1.20 minus the product of 20,000 x \$.75, divided by 2 years).

INCOME-TAX CONSIDERATIONS

The cumulative compensation expense recognized for an award that would result in a future tax deduction would be considered a deductible temporary difference under Statement 109.⁴ Therefore, the deductible temporary difference is based on the fair value of the award recognized for financial-reporting purposes. Under U.S. tax law, deductions are measured as the intrinsic value of an award at a specific date. As a result, differences would be likely between the amount of deferred tax asset recognized and the ultimate tax benefit realized for income-tax purposes. Tax benefits realized in excess of the amount recognized for financial-reporting purposes would be recognized as additional paid-in capital at the time the tax benefit is realized.

However, if the tax benefit ultimately realized is less than the amount recognized for financial-reporting purposes, the difference would be recognized as tax expense. This treatment contrasts with Statement 123's. Under Statement 123, the difference would be offset against amounts previously credited to additional paid-in capital from excess tax deductions from previous share-based awards.

COMPARISON WITH IFRS 2

The FASB has worked closely with the IASB in an attempt to achieve as much convergence as possible on accounting for share-based awards. Both the FASB and IASB have concluded that compensation expense should be measured based on the fair value of the award determined at the grant date and recognized over the service period. Nevertheless, there are differences between IFRS 2 and the FASB's exposure draft. The major differences are identified below.

- *Fair-Value Measurement.* Both IFRS 2 and the FASB's exposure draft require the use of fair value in recognizing compensation expense for share-based awards to employees, and in most cases companies would be required to determine fair value by using a valuation model. However, the FASB's exposure draft expresses a stronger preference in favor of using a lattice model than does IFRS 2. Thus, the use of a closed-form model could be more common under IFRS 2 than under the requirements proposed in the FASB's exposure draft. In addition, only the FASB's exposure draft allows nonpublic entities to elect the intrinsic-value method.
- *Accounting for Income Taxes.* IFRS 2 requires deferred taxes to be adjusted each reporting period based on the current share price, whereas the FASB's exposure draft would retain the requirement that deferred taxes not be adjusted based on period-to-period changes in the share's market price. At the time the tax benefit is realized by the employer, the two sets of requirements would result in the same cumulative treatment for the tax provision. However, there could be significant period-to-period differences between accounting for income taxes under IFRS 2 and the exposure draft.
- *Scope.* IFRS 2 addresses all share-based awards, but the scope of the exposure draft is limited to share-based awards to employees, postponing consideration of accounting for share-based awards to nonemployees and ESOPs to a subsequent phase of the FASB's project. Until then, the provisions of Statement 123 and EITF 96-18 will continue to apply to awards to nonemployees,⁵ leading to recognition and measurement differences between presentations under U.S. GAAP and presentations under IFRS 2.

(4) FASB Statement No. 109, *Accounting for Income Taxes*, February 1992.

(5) 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."



EFFECTIVE DATE AND TRANSITION

The proposed requirements in the exposure draft would be effective for public companies and nonpublic companies that did not use the minimum-value method as of the beginning of the first fiscal year beginning after December 15, 2004. Calendar-year-end public companies and affected nonpublic companies would therefore be required to adopt the final requirements in their first quarter 2005 financial statements. No alternative transition method would be permitted for companies that had voluntarily adopted the recognition provisions of Statement 123. As a result, compensation expense for 2005 and later years would be the same whether a company had adopted fair-value recognition under Statement 123 or waited until required to adopt a final Statement on share-based awards. Nonpublic companies that used the minimum-value method would have an additional year to adopt the new Statement. Early adoption would be permitted for all companies if financial statements have not been issued for the periods prior to the effective date. Restatement of prior-year financial statements would not be permitted for public or nonpublic companies.

Equity-Classified Awards. Companies would recognize compensation cost for all equity-classified awards granted, modified, or settled after the effective date using the exposure draft's fair-value measurement method. In addition, compensation expense would be recognized for the unvested portion of awards outstanding as of the effective date based on their grant-date fair value as calculated under the original provisions of Statement 123. For example, a calendar-year-end company's awards granted or changed on or after January 1, 2005 would be valued and expensed using the exposure draft's provisions, whereas unvested awards at January 1, 2005 would maintain their original fair value (computed under the provisions of Statement 123) and would be expensed in 2005 and later years over the remaining vesting period.

Liability-Classified Awards. Public companies would report a cumulative effect of a change in accounting principle for liability-classified awards, calculated as the difference between the award's fair value as required by the exposure draft and its intrinsic value on the effective date.

Nonpublic Companies. Most nonpublic companies would apply the provisions of the final Statement prospectively and would *not* apply it to the nonvested portion of awards granted before the date of adoption. A cumulative effect of a change in accounting principle would be recognized for liability-classified awards by nonpublic companies that choose to adopt the fair-value method of accounting for their awards.



The FASB intends to process comments on the exposure draft and complete additional deliberations so that it can produce a final Statement during the fourth quarter of 2004, in time for adoption for calendar 2005 reporting periods.

Companies should not treat the descriptive and summary statements about the exposure draft as if they represent what the FASB will ultimately adopt. Nor should companies treat the statements in this presentation about potential accounting requirements or about provisions of IFRS 2 as if they pertain to any company's unique circumstances. Companies should refer to the text of the final FASB Statement when it is completed and published and to the text of IFRS 2 and should consult their accounting and legal advisors.

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