



## Expensing Stock Options Becomes Mandatory

New FASB Statement 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees, but expresses no preference for a type of valuation model.<sup>1</sup> The Statement is effective for most public companies' interim or annual periods beginning after June 15, 2005 (the third quarter for calendar-year-end companies) and is effective for nonpublic companies for annual periods beginning after December 15, 2005. Companies adopting the new requirements are likely to reexamine their valuation methods and the support for the assumptions that underlie the valuation of the awards. Many are also likely to carefully examine their share-based-payment programs.

### Scope

Statement 123R sets accounting requirements for "share-based" compensation to employees, including employee-stock-purchase-plans (ESPPs). It carries forward prior guidance on accounting for awards to nonemployees.<sup>2</sup> Accounting for employee-stock-ownership-plan transactions (ESOPs) will continue to be accounted for in accordance with SOP 93-6.<sup>3</sup> Awards to most nonemployee directors will be accounted for as employee awards.

### Classifying Awards as Liabilities or Equity

The way an award is classified will affect the measurement of compensation cost. Liability-classified awards are remeasured to fair value at each balance-sheet date until the award is settled. Equity-classified awards are measured at grant-date fair value and are not subsequently remeasured.

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<sup>1</sup> FASB Statement No. 123 (Revised 2004), Share-Based Payment: an amendment of FASB Statements No. 123 and 95, December 2004, available at [www.fasb.org](http://www.fasb.org).

<sup>2</sup> FASB Statement No. 123, Accounting for Stock-Based Compensation, October 1995 and 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.

<sup>3</sup> AICPA Statement of Position No. 93-6, Employers' Accounting for Employee Stock Ownership Plans, November 1993.

Many employee awards with cash-based settlement or repurchase features, such as a stock appreciation right with a cash-settlement option, are liability-classified awards under Statement 123R. So too are awards for a fixed dollar amount settleable in the company's stock. Share-based awards with net-settlement features for minimum tax withholdings are equity-classified. However, a net-settlement feature for an amount in excess of the minimum tax withholding causes an entire award to be liability-classified. Awards that permit a cashless exercise using a broker unrelated to the employer generally are equity-classified. If the employer uses a related broker, the broker must sell the shares in the open market within the normal settlement period for the award to be equity-classified. In addition, a put feature that gives employees the right to require the company to repurchase the shares at fair value is equity-classified if the employee bears the risks and rewards normally associated with ownership for six months or longer.

If an award vests or becomes exercisable based on the achievement of a condition other than a service, performance, or market condition, the award is liability-classified. Service, performance, and market conditions are explained below under Recognizing Compensation.

### **Determining Grant-Date Fair Value**

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 conditions required for the award to vest. The estimate of fair value would reflect transfer-

ability 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 share options would be incorporated into the estimate of grant-date fair value. Service and performance vesting conditions do not directly affect an award's fair value. Both conditions are reflected by recognizing compensation cost over the requisite service period 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 are required to use a valuation method that market participants would use to value the award. Statement 123R expresses no preference for either a lattice model (e.g., a binomial model) or a closed-form model (e.g., a Black-Scholes-Merton model). The exposure draft had stated that a lattice model is preferable to a Black-Scholes-Merton model for valuing share options because it can accommodate more potential post-vesting behaviors, but the final requirements take a neutral position.<sup>4</sup>

**Equity-Classified Awards.** An equity-classified award with an observable market price (e.g., a grant of nonvested shares) is valued at that price. Otherwise the award is 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 (commonly referred to as a restricted stock grant) is valued at the market price of the shares on the date of grant.

**Liability-Classified Awards.** Public companies' liability-classified awards are remeasured to fair value each reporting period. Prior to vesting, cumulative compensation cost equals the proportionate amount of the award earned to date. For example, if a liability-classified award has a current fair value of \$50,000 and the employee has rendered 60 percent of the requisite service, the cumulative compensation cost recognized to that point would be \$30,000. Subsequent to vesting, the entire change in fair value is recorded in earnings. Under the accounting requirements being superseded, liability-classified awards are remeasured to intrinsic value. Public companies will therefore have to apply a cumulative-effect adjustment related to their liability-classified awards so that the recorded liability amounts are at fair value.

**Measurement Alternatives for Nonpublic Companies.** The new Statement permits nonpublic companies using an option pricing model to substitute the historical volatility of an appropriate industry sector share-price index for the expected volatility of their share prices if insufficient information is available to estimate expected volatility. The awards are then said to be valued at "calculated" value rather than at fair value. Statement 123's minimum-value method, which omits volatility, will no longer be permissible.

Nonpublic companies will be required to decide whether to measure their liability-classified awards at fair value (or calculated value) or at intrinsic value (the amount by which the underlying share's market price exceeds the award's exercise price). Since the

<sup>4</sup> FASB Exposure Draft, *Share-Based Payment: an amendment of FASB Statements No. 123 and 95*, March 31, 2004.

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

The grant-date fair value of an equity-classified award is recognized in earnings over the requisite service period. The requisite service period may be stated, either explicitly or implicitly, or it may need to be derived from the terms of the award.

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). The specified duration of employment is explicit (two years, for example). 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). A performance condition's service period may be either explicit (such as three years) or implicit. An example of a performance condition that creates an implicit service period is an award that vests when the company's market share exceeds 30 percent. In such cases, the company has to estimate when the target is expected to be achieved.

A market condition affects the exercisability of an award, not its vesting, according to the new Statement. 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 shares is above \$80 per share for 30 consecutive trading days). If an award's exercisability depends entirely on achieving a market condition, the requisite service period must be derived from the valuation model.

Because more than one condition can apply to an award, there can be more than one explicit, implicit, or derived service period. In such situations, the company must determine from these service periods which is the requisite service period for purposes of recognizing compensation. Starting with the simplest situation, if an award has only one explicit, implicit, or derived service period, the requisite service period would be that service period. If an award contains two or more service periods, the requisite service period depends on whether the conditions are in an "or" or an "and" relationship. The requisite service period is the shortest of the periods that are in an "or" relationship. The requisite service period is the longest of the periods in an "and" relationship.

For example, if an award vests after four years of service (explicit) *or* when the company's EPS exceeds \$3.00 for a quarter (implicit), the requisite service period would be the *shorter* of the service periods. Conversely, if the award vests upon the completion of four years of service (explicit) *and* the company's stock price exceeding \$50 per share for 10 consecutive trading days (derived), the requisite service period would be the *longer* of the service periods.

Compensation cost is recognized based on the number of awards that eventually vest. The amount accrued each period until the

vesting date is based on the estimated number of awards that are expected to vest. The estimate is 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 the superseded provisions, which permit companies to use either the approach based on an estimate or to recognize compensation cost by assuming all awards will vest, adjusting for actual forfeitures as they occur. Companies that did not use the approach based on an estimate of forfeitures under Statement 123 will therefore have to report a cumulative-effect adjustment when adopting Statement 123R to incorporate the estimated forfeitures.

In all cases, if the employee works for the requisite service period, recognized compensation cost is not reversed even if the award expires unexercised. Therefore, if the employee worked for the requisite service period, the employee's inability to exercise an award because a market condition is not achieved does not cause recognized compensation cost to be reversed.

Compensation cost for awards that vest when a performance condition is achieved will be recognized over the requisite service period if the condition is probable of achievement. If a performance condition is initially considered not probable of achievement but is subsequently considered probable of achievement, the company must recognize the cumulative amount of compensation earned to that point. Conversely, a change in the estimated requisite service period is recognized prospectively. The boxed examples illustrate recognizing share-based compensation subject to performance conditions.

## Share-Based Compensation Subject to Performance Conditions

**Case 1.** Company A decides to add to its traditional compensation plan a share-based payment arrangement that contains “stretch” goals for key members of its sales unit. The company therefore grants 10,000 share options with a grant-date fair value of \$6 per award to the sales unit’s senior members. All awards cliff vest after three years if the market share of one of Company A’s key products exceeds 25 % (that is, the share options cannot vest before the end of the three-year period). Company A initially determines that it is *not* probable that the market share will exceed 25%. Based on improved sales in Year 2, the company determines in Year 2 that the market share target is now probable of achievement. At the end of Year 2, Company A would recognize the cumulative amount of compensation cost based on the percentage of the requisite service rendered to date, as shown in the table, assuming no forfeitures occur during the vesting period.

	Year 1	Year 2	Year 3
Total compensation cost that is probable of achievement:			
Number of awards expected to vest	-	10,000	10,000
Fair value per award	\$6	\$6	\$6
	-	\$60,000	\$60,000
Proportion of service period completed at year-end	1/3	2/3	3/3
Cumulative compensation cost recognized at year-end	-	\$40,000	\$60,000
Cumulative compensation cost previously recognized	-	-	\$40,000
Current period compensation cost	-	\$40,000	\$20,000

**Case 2.** Company B grants 50,000 nonvested shares to members of management that vest when quarterly sales reach \$100 million. The grant-date fair value is \$3 per award. Based on its forecasts, it is probable Company B’s quarterly sales will exceed \$100 million at the end of three years. Therefore, compensation cost is initially recognized over a three-year requisite service period. Assume that at the beginning of Year 2, Company B’s revised forecast indicates that it is now probable quarterly sales will exceed \$100 million at the end of five years. Because of the change in the estimate of the requisite service period, all remaining unrecognized compensation cost is recognized prospectively through the end of the revised requisite service period, as shown in the table assuming no forfeitures occur during the vesting period.

Total compensation cost (50,000 x \$3 per award)	\$150,000
Year 1	
Total compensation cost	\$150,000
Requisite service period	3 years
Current year compensation cost recognized	\$50,000
Years 2 through 5	
Total compensation cost	\$150,000
Less compensation cost recognized in Year 1	\$50,000
Remaining unrecognized compensation cost	\$100,000
Revised <i>remaining</i> requisite service period	4 years
Current year compensation cost (Years 2 –5)	\$25,000

**Awards with Graded Vesting.** Companies that grant awards with graded vesting, such as an award that vests 25 percent at the end of each year over four years, will have to make a policy election, choosing between two approaches. The first approach is to treat each vesting tranche as a separate award with compensation cost for each award recognized over its vesting period. This approach results in a greater amount of compensation cost recognized in the earlier periods of the grant with a declining amount recognized in later periods. The second approach is to treat

the award as a single award for recognition purposes (although the company may value each tranche separately) and recognize compensation cost on a straight-line basis over the vesting period of the entire award. In marked contrast, the exposure draft would have required companies to treat each vesting tranche of an award as a separate award.

### Modified Awards

An award may be modified by changing its exercise price, extending its life, or revising its vesting conditions. The accounting for an

award modification depends on the likelihood, at the date of the modification, that the original award would have vested. If it is *not* at that time probable that the original award would have vested, the cumulative compensation to be recognized would be the value of the modified award. This situation commonly arises when an employee is to be terminated prior to vesting of the award and the employer changes the award so that it vests at the employee’s termination. In that case, the recognized compensation would equal the fair value of the modified award at the

date of the modification. However, 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 C grants 20,000 equity-classified awards with an exercise price of \$10 per award in Year 1. The grant-date fair value per award is \$5, yielding a total grant-date fair value of \$100,000. The awards cliff vest after four years of service, and no forfeitures occur. In Year 3, because its stock price has declined significantly, Company C 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 have a fair value at the date of grant of \$.75 (with an exercise price of \$10, they are deeply out-of-the-money). Company C will recognize compensation cost of \$25,000 in each of Years 1 and 2 (\$100,000 value of the original award divided by the four-year requisite 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 C would recognize compensation cost of \$29,500 calculated as the amount from the original award (\$25,000 per year) 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).

For contrast, assume that in Year 3, Company C decided to terminate the employees. As

part of the termination package, Company C determined that the awards would be immediately vested. The fair value of the awards at the date of modification is \$7, and the total fair value is \$140,000. It is not probable that the original awards would have vested, because under their original terms, the employees would have forfeited the awards when they were terminated. The total compensation therefore equals the fair value of the modified awards (\$140,000). Company C previously recognized \$50,000 (\$25,000 in each of Years 1 and 2), so it would recognize the \$90,000 difference at the time of the modification.

### ESPPs Usually Compensatory

ESPPs are compensatory under the new Statement if they fail to meet any of three conditions. Most ESPPs would be compensatory either because the plan contains a “look-back” feature or because the plan contains a purchase price discount larger than the Statement categorizes as noncompensatory (generally five percent).<sup>5</sup>

### Income-Tax Considerations

The cumulative compensation cost recognized for an award that would result in a future tax deduction is a deductible temporary difference under Statement 109.<sup>6</sup> Therefore, the deductible temporary difference is based on the compensation cost recognized for financial-reporting purposes. Under U.S. tax law, deductions are based on the intrinsic value of an award at a specific date, generally at exercise. As a result, differences are likely between the compensation cost recognized for financial-reporting purposes and the deduction for tax purposes. If a tax benefit realized exceeds the amount recognized for

financial-reporting purposes (i.e., intrinsic value at exercise exceeds grant-date fair value), the excess is 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 is first offset against amounts previously recognized as additional paid-in capital from excess tax deductions from previous share-based awards. Any remaining “short-fall” is recognized as tax expense. This treatment differs from the proposal in the exposure draft, which would have reported all deficiencies as tax expense.

In determining the balance within additional paid-in capital available for offset, companies will be able to use the amount of excess tax benefits that would have existed had they initially chosen to recognize share-based compensation cost under Statement 123. However, many companies might find it difficult to gather the needed information.

### Relationship to IFRS 2

The FASB worked closely with the IASB in order to achieve as much convergence as possible in accounting for share-based awards. Both the FASB and IASB have concluded that compensation cost should be measured based on the fair value of the award determined at the grant date and recognized over the requisite service period. Nevertheless, there are differences between IFRS 2 and Statement 123R.<sup>7</sup> Both Boards have stated their intention to work to narrow the differences, but no timetable has been established.

<sup>5</sup> FASB Technical Bulletin No. 97-1, *Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option*, December 1997.

<sup>6</sup> FASB Statement No. 109, *Accounting for Income Taxes*, February 1992.

<sup>7</sup> International Financial Reporting Standard 2, *Share-Based Payment*, February 2004.



This is a publication of KPMG's  
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**Effective Date and Transition**

The new Statement is effective for public companies that do not file as small business issuers as of the beginning of interim or annual reporting periods that begin after June 15, 2005. Calendar-year-end public companies are therefore required to adopt the new Statement in their third-quarter 2005 financial statements. Small business issuers are given an additional six months to adopt the new Statement. Nonpublic companies are required to adopt the new Statement for annual periods beginning after December 15, 2005.

All public companies (including small business issuers) and those nonpublic companies that used the fair-value method (rather than the minimum-value method) must use either the modified prospective or the modified retrospective transition method. Under the modified prospective method, awards that are granted, modified, or settled after the date of adoption should be measured and accounted for in accordance with Statement 123R. Unvested equity-classified awards that were granted prior to the effective date should continue to be accounted for in accordance with Statement 123 except that amounts must be recognized in the income statement. Under the modified retrospective approach, the previously-reported amounts are restated (either to the beginning of the year of adoption or for all periods presented) to reflect the Statement 123 amounts in the income statement.

No alternative transition method is permitted for companies that had voluntarily adopted the recognition provisions of Statement 123. As a result, compensation cost after the effective date will be the same whether a company had adopted fair-value recognition under Statement 123 or waited until the required adoption of the new Statement.

Nonpublic companies that used the minimum-value method must adopt the new Statement on a prospective basis. Therefore, only awards granted after the adoption of Statement 123R will be reflected in those companies' income statements. Early adoption is permitted for all companies.

**Liability-Classified Awards.** Public companies and nonpublic companies that elect the fair-value method of accounting for liability-classified awards will report a cumulative effect of a change in accounting principle, calculated as the difference between the award's fair value as required by the new Statement and its intrinsic value on the effective date.



Companies preparing to adopt Statement 123R will have to determine the transition method they will use and whether to adopt the Statement's requirements early. Many are also likely to consider re-evaluating the inputs used to determine grant-date fair value and how well they are supported. Since all forms of share-based payments granted to employees will be recognized in the income statement, some companies are now considering changes in their compensation programs.

The descriptive and summary statements above are not intended to substitute for the texts of FASB Statement 123R, the other FASB literature cited, and IFRS 2 and are not necessarily applicable to any company's particular circumstances. Companies should refer to the texts of the applicable documents that set out requirements and should consult their accounting and legal advisors.