

Defining Issues[®]

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FASB and SEC Guidance on Applying Statement 123R

The FASB proposed new Staff Positions on determining the grant date of a share-based payment and on a simplified transition method for computing the available excess tax benefits in additional paid-in capital at the time Statement 123R is adopted,¹ and the SEC's economists reported their analysis of using market instruments to value employee stock options.² This edition of *Defining Issues* summarizes the new guidance.

Grant-Date Guidance

Statement 123R's definition of a share-based award's grant date includes the characteristic that the employer and the employee must have "a mutual understanding" of the award's key terms and conditions.³ For employers who communicate with each employee individually, this could mean that the grant dates and therefore the grant-date fair values differ within the employee population based on when employees are notified of the award. The other three elements of the grant-date definition are (1) that the award is authorized (unless approval is a formality), (2) that the employer is conditionally obligated to deliver equity instruments or transfer assets if the employees provided the requisite service, and (3) that the employee begins to benefit from changes in the company's stock price or to be adversely affected by it.

The FASB's proposed Staff Position on the mutual-understanding criterion is intended to make available a practical approach to determining the grant date. Under the proposal, the mutual-understanding criterion is presumed to be satisfied at the date the award is approved under relevant corporate governance requirements if the other three elements of the definition of the grant date are met and these two conditions are also met:

- The recipient is unable to negotiate the key terms and conditions of the award, and

Grant-Date Guidance	1
Tax Effects of Share-Based Payment Awards	2
Using Market Instruments to Measure Fair Value	3

¹ Proposed FASB Staff Positions FAS 123(R)-b, Practical Exception to the Application of Grant Date as Defined in FASB Statement 123(R), and FAS 123(R)-c, Alternative Transition Option Related to Accounting for the Tax Effects of Share-Based Payment Awards, available at www.fasb.org.

² Office of Economic Analysis, SEC, Economic Evaluation of Alternative Market *instrument designs*: Toward a Market-Based Approach to Estimating the Fair Value of Employee Stock Options, available at sec.gov/news/extra/memo083105.htm.

³ FASB Statement No. 123 (revised 2004), Share-Based Payment, December 2004, available at www.fasb.org.

- The award's key terms are expected to be communicated to the employees within a relatively short period of time after the date of approval.

This approach to establishing a mutual understanding would be consistent with other accounting literature that addresses compensation, for example, employer notification of a negative plan amendment to a defined benefit postretirement plan.

The proposed Staff Position contains no quantitative guidelines for determining a "relatively short time period." However, it does say that a "relatively short time period" is the period during which the entity can "plausibly" complete all actions necessary to communicate the awards under its customary human-resource practices. Companies will therefore need to consider the number of award recipients as well as their location in concluding that they will communicate the award to all employees in a "relatively short time period."

If the proposed guidance is adopted, it should ease implementation problems for many companies, particularly those that give broad-based grants to employees in locations around the world. The proposal's comment deadline is October 1, 2005. It would become effective when an entity adopts Statement 123R or, if it has already adopted Statement 123R, in the first reporting period beginning after the Staff Position is posted to the FASB's Web site.

Tax Effects of Share-Based Payment Awards

The FASB has proposed a simpler alternative to Statement 123R's calculation of the amount

of excess tax benefits available in additional paid-in capital to absorb tax deficiencies that occur after adopting Statement 123R. The proposal on determining what the FASB has dubbed the "APIC pool" responds to feedback about difficulties in applying the requirements in paragraph 81 of Statement 123R. Under paragraph 81, the APIC pool when Statement 123R is adopted is calculated on an award-by-award basis, as if the recognition provisions of Statement 123 had been followed since the adoption of Statement 123 (1995 for calendar-year companies).⁴

Under the newly proposed alternative transition method, an entity may elect to calculate the beginning balance of the APIC pool as:

- The sum of all tax benefits from share-based compensation recognized in additional paid-in capital during the fiscal periods that Statement 123 was applied (whether for recognition or pro forma disclosure),
- Less the product of cumulative gross compensation cost reported under Statement 123 (whether for recognition or pro forma disclosure) multiplied by the entity's current blended statutory tax rate (inclusive of federal, state, local, and foreign taxes).

The proposed Staff Position would permit companies up to one year after the adoption of Statement 123R to decide whether to elect the alternative method for computing the APIC pool. Companies would be required to disclose the method elected.

Fully Vested, Unexercised Awards at Adoption. Under the alternative approach in

the proposed Staff Position, tax benefits realized subsequent to adopting Statement 123R on awards that were fully-vested at the time of adoption would increase the APIC pool. For example, assume Company A issued 100 share options with an exercise price of \$8 in June 2000 that vested over a three-year period. The company accounted for its awards using the recognition provisions of APB 25 and did not record either compensation cost or tax benefits for the award.⁵ The company adopts Statement 123R on January 1, 2006, and the share options are exercised in June 2006, when the stock price is \$18, resulting in a tax deduction of \$1,000 (100 shares x [\$18 - \$8]). The tax benefit of the deduction (\$400 = \$1,000 x 40%) is recognized as an increase in additional paid-in capital. Under the alternative transition method, the exercise would also increase the APIC pool by the same amount (\$400). Had the company applied the transition method required by Statement 123R, only the excess tax benefit (that is, excess of the tax deduction over the cumulative compensation cost recognized multiplied by the tax rate) would increase the APIC pool.

Partially-Vested Awards. The effect on the APIC pool of an award that is partially vested when Statement 123R is adopted would be determined following Statement 123R's requirements. The tax deduction realized for a partially-vested award would be compared to the sum of compensation cost recognized or disclosed for that award under Statement 123 and Statement 123R to determine the related deferred tax asset (or the hypothetical deferred tax asset for compen-

⁴ FASB Statement No. 123, *Accounting for Stock-Based Compensation*, October 1995, available at www.fasb.org.

⁵ APB Opinion No. 25, *Accounting for Stock Issued to Employees*, October 1972.

sation cost reported through pro forma disclosure). When the partially-vested award is exercised, only the excess tax benefit would increase the APIC pool, whether the company uses the alternative transition method or the transition method specified in Statement 123R. In either case, however, the entire tax benefit on the portion of the award that was vested at the date of adoption would be recorded as an increase in additional paid-in capital.

Cash Flow Statement Presentation. Statement 123R requires that the excess tax benefit that is recognized as an addition to the APIC pool be reported as a financing activity in the statement of cash flows. Under the proposed alternative transition approach, all of the tax benefits recognized on awards that are fully vested prior to the adoption of Statement 123R would be reported as a financing activity. For partially-vested awards, only the amount that is determined to be the excess tax benefit would be reported as a financing activity in the statement of cash flows.

The FASB is moving quickly on the proposed Staff Position. The deadline for submitting comments is October 8, 2005.

Using Market Instruments to Measure Fair Value

The SEC's Office of Economic Analysis (OEA) recently provided guidance on the use of market-based measures to estimate the fair value of employee share-based pay-

ments. They concluded that in determining the fair value of a financial instrument, prices obtained from active markets for identical or similar instruments indicate fair value better than estimates derived from valuation techniques. However, currently there are no active markets for employee share-based awards, and the awards are not comparable to traded options because of their longer lives, restrictions on transferability, and employee exercise behavior.

Several registrants had asked the SEC staff whether instruments with terms and conditions similar to those of employee awards that are issued to selected investors might provide a basis for valuing employee share options. In its analysis, the OEA identified three main issues: (1) instrument design, (2) a credible information plan, and (3) a market pricing mechanism. Most of the OEA's analysis focused on instrument design because, as the report explained, credible information and a market pricing mechanism are not currently available for the proposed instruments.

The OEA identified two possible approaches to instrument design. The first is a *tracking* approach, with payoffs similar to those of the employee awards. For example, an instrument might base the payoff to the investor on future intrinsic values realized by employees, or a third party might assume the employer's obligations to the employee. The second is a *terms and conditions* approach in which the terms of the instrument are similar

to the terms of the employee award, but exercise behavior and payoffs are driven by investor preferences.

The OEA's evaluation of possible market-based measures focused on the cost to the entity of issuing shared-based awards. The cost to the entity depends on employees' exercise behavior. The OEA believes that because the tracking approach matches the net obligations to the entity or the net receipt to holders, suitable market-based measures *might* be developed that use this approach. However, because investor exercise behavior is likely to differ from employee exercise behavior, a terms and conditions approach would not yield a price that indicates the fair value of employee share options.

The OEA also noted that in marketing an instrument from which pricing information might be used to estimate an employee award's fair value, investors would need information about employee exercise behaviors sufficient to allow them to price the instrument. In addition, a market pricing mechanism, with willing buyers and sellers, would be needed to encourage participation, to promote competition, and to obtain a fair-value price.

The SEC Chairman and Chief Accountant welcomed the potential use of market-based measures to estimate the fair value of employee share-based payments, but concluded that no such measures are currently available. The Chief Accountant also held



that if market-based measures were available and diverged significantly from model-derived values (e.g., from those derived using a Black-Scholes-Merton model), the company would need to resolve the differences.⁶



Under the SEC's deferred effective date for applying Statement 123R, public-company registrants that are not small business filers must apply the Statement as of the beginning of their first annual period beginning after June 15, 2005.⁷ Public companies that are not small business filers and have fiscal years ending in June, July, or August will apply the Statement at its original effective date, the beginning of the first annual period that begins after June 15, 2005. Nonpublic companies and public companies that are small business filers must apply the Statement as of the beginning of the first annual reporting period that begins after December 15, 2005.

The descriptive and summary statements above are not intended to substitute for the text of the proposed FASB Staff Positions; Statements 123R and 123; APB Opinion 25; or any other cited, actual, or potential requirements. Nor are any of the cited documents necessarily applicable to any entity's specific circumstances. Those accounting for share-based-payment arrangements and complying with SEC filing requirements should refer to the texts of the applicable documents that set out requirements and consult their accounting and legal advisors.

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⁶ Donald T. Nicolaisen, Statement Regarding Use of Market Instruments in Valuing Employee Stock Options, September 9, 2005, available at sec.gov/news/speech/spch090905dtn.htm.

⁷ SEC Release No. 33-8568, Amendment to Rule 4-01(a) of Regulation S-X regarding the Compliance Date for Statement of Financial Accounting Standards No. 123 (Revised 2004), *Share-Based Payment*, April 15, 2005, available at sec.gov.