

Defining Issues[®]

KPMG LLP



Statement 123R Implementation Challenges

Applying FASB Statement 123R on accounting for share-based-payment arrangements can impose difficult data-gathering and evaluative tasks that companies need to address to be ready to adopt the Statement efficiently, support assertions, and adjust their systems.¹ This edition of *Defining Issues* explains potential challenges facing those responsible for implementing the requirements in Statement 123R and in the SEC staff's SAB 107.²

Statement 123R does not merely take the disclosure measurements from Statement 123 and make them applicable to the income statement.³ Companies, for example, will have to reconsider which valuation model to apply, support the assumptions used in the model, reevaluate how they classify their awards and measure those liability-classified at fair value, estimate the number of awards that will be forfeited, and gather and evaluate the data needed to determine the pool of excess tax benefits at the time Statement 123R is adopted.

Valuation

Most companies that have been valuing share-based payment awards have used a closed-form model, such as Black-Scholes-Merton. However, Black-Scholes-Merton may not be able to reliably value an award with certain characteristics, such as a market condition. In these situations, companies will need to consider another valuation approach, for example, a lattice valuation model or a simulation approach.

A lattice model requires much more detailed information about employee groups and employee behavior than Black-Scholes-Merton. However, if sufficient reliable information is available about suboptimal exercise behavior, post-vesting termination rates, and other relevant factors, a lattice model may produce a better estimate of grant-date fair value.

Supporting Assumptions. No matter what valuation approach is used, the assumptions in the model will have to be supported by substantive analysis. Companies will have to consider the need to stratify their grantee population into groups with relatively homogeneous employee exercise behavior to support the expected-term assumption. The grantee population could be stratified, for example, by age, level in the organization, or geographic location. While SAB 107 states that stratifying into one or two groupings might be appropriate in certain circumstances, some companies will find that more groupings are needed to develop reliable and supportable data about employee exercise behaviors.

Valuation	1
Liability or Equity Classification?	2
Determining the Service Period	2
Graded Vesting	3
Estimate of Forfeitures	3
Offsetting Tax Deficiencies	3
Effect of Compensation	4
Strategies	4
Systems and Controls	4

©2001-2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative. All rights reserved. A16595NYGR

GettyImages/S Wanke/Photolink/Photodisc Green LS005631

¹ FASB Statement No. 123 (revised 2004), Share-Based Payment, December 2004, available at www.fasb.org.

² SEC Staff Accounting Bulletin No. 107, Share-Based Payment, March 2005, available at www.sec.gov.

³ FASB Statement No. 123, Accounting for Stock-Based Compensation, October 1995, available at www.fasb.org.

Expected Term. In developing an expected-term estimate, companies must look beyond the awards that have been exercised. The expected-term estimate must reflect both exercised and unexercised awards—even when it appears likely that those awards will expire unexercised because they are out-of-the-money.

Companies with insufficient historical-exercise data may use a simplified method suggested in SAB 107 to estimate the expected term for “plain vanilla” share options, provided the awards meet the SAB’s criteria and only until the end of 2007.

Expected Volatility. Companies that apply Statement 123R are required to develop assumptions about expected share-price volatility. When they are preparing to adopt the Statement, they will need to consider the availability of relevant information and how to gather it.

The needed information includes historical stock-price data to compute the historical volatility for a period commensurate with the expected term of the award (for multiple time periods if the company has been public for a sufficiently-long period of time), implied volatility if actively-traded options are available, and the trends in historical and implied volatilities. Companies will also need to consider recent or foreseeable events that may affect the volatility of their shares and how those events may affect the trend of either historical or implied volatility—events such as a major change in capital structure or in the nature of the business brought about by a large acquisition or disposal.

Companies that cannot place exclusive reliance on either historical volatility over a term commensurate with the expected term of the award or the implied volatility derived from the market prices of traded options will have to assign weights to the various measures of volatility, a difficult judgmental task. They will have to establish processes for gathering volatility data and for determining the appropriate weights to assign to the measures in

order to estimate expected volatility when valuing share-option awards.

Statement 123 permitted nonpublic companies to use a volatility assumption of zero percent in valuing their awards, an approach that produces “minimum value,” rather than fair value. Statement 123R eliminates that alternative. However, it does permit a nonpublic company that cannot make a reasonable estimate of its equity securities’ volatility to use the historical volatility of an index of companies in a similar industry. The resulting value is called calculated, rather than fair, value. In many cases, however, volatility information about the disaggregated components of an index will be available, and fair value can be determined.

Liability or Equity Classification?

Companies will have to reevaluate how they classify their awards and measure liability-classified awards at fair value. Statement 123R’s guidance on classifying awards is more detailed than Statement 123’s or Opinion 25’s.⁴ The Statement-123R analysis should consider all substantive terms that may affect the award, including those in agreements other than the award agreement. The analysis should also consider the company’s intent and past settlement practices if they differ from the award’s written terms. Statement 123R requires public companies to measure liability-classified awards at fair value (adjusted each financial-statement date until the award is settled). They are measured at intrinsic value under Statement 123 and Opinion 25. Nonpublic companies are permitted, as an accounting policy election, to measure liability-classified awards at intrinsic value (adjusted each financial-statement date until the award is settled).

Awards that were equity-classified under Statement 123 or Opinion 25 may become liability-classified at the time a company adopts Statement 123R. If so, the company will have to report the cumulative effect of the change in accounting principle in income at the time that Statement 123R is adopted to

adjust the previously-recorded amount of the award to its fair value at the date of adoption or to intrinsic value at that date in the case of nonpublic companies that elect the intrinsic-value accounting policy. These awards will have to be remeasured to fair or intrinsic value, respectively, at each subsequent financial-statement date. Companies will need processes to perform the remeasurements.

When adopting Statement 123R, both public companies and those nonpublic companies making the fair-value accounting policy election will also need to determine the fair value of awards that were previously liability-classified under either Statement 123 or Opinion 25 (e.g., a cash-settled stock appreciation right). The difference between the award’s fair value at that date and its intrinsic value will have to be included in income as a cumulative effect of the change in accounting principle in the period that Statement 123R is adopted. In subsequent periods these awards will be remeasured to fair value, not to intrinsic value, as has been the case under Statement 123 and Opinion 25.

Determining the Service Period

Statement 123R requires that the grant-date fair value of an equity-classified share-based payment award be recognized over its requisite service period. All substantive terms and conditions of an award should be considered when determining the requisite service period, but related terms can effectively eliminate what may appear to be a vesting provision.

For example, assume a company grants share-based payment awards that have a four-year stated service condition, but that an employee’s retirement causes his or her invested award to vest. In this case, an employee who is retirement-eligible at the grant date has no effective service-period requirement, since the employee can retire immediately and be vested in the award. This issue also arises when an employee becomes retirement-eligible before the expiration of the explicit service period.

⁴ Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, October 1972.

Illustrations in Statement 123R contain guidance on determining the requisite service period for awards with a noncompete agreement.⁵ In some situations, a noncompete agreement should be treated as a clawback provision that is not accounted for unless the event occurs. Other noncompete provisions may create a substantive vesting term, and the compensation cost should be recognized over the period of the noncompete agreement. However, the FASB staff has stated that non-compete arrangements will in most circumstances be treated as clawback provisions.

Graded Vesting

Statement 123R's approach to graded vesting conditions is different from Statement 123's. Statement 123R allows a choice between two accounting policies. Graded vesting awards vest in stages over the life of the award. A four-year award with a graded vesting condition might, for example, vest 25 percent of the award each year during the four-year period.

Under Statement 123, if the grant-date fair value of an award with graded-vesting conditions is computed for each vesting tranche, the company is required to recognize compensation cost for each tranche over its requisite service period. Statement 123R permits

companies to make an accounting policy election to either recognize compensation cost for each tranche over its vesting period or to treat the tranches as one award, recognizing the amount ratably over the entire period, provided the cumulative amount recognized to date is at least equal to the portion of the award vested to date. If ratable recognition is elected when Statement 123R is adopted, the company does not have to demonstrate that the new policy is preferable. However, if the policy is changed after Statement 123R is adopted, the company would have to demonstrate that the new policy is preferable. Companies that typically grant graded-vesting awards will therefore want to consider this policy alternative at the time Statement 123R is adopted.

Estimate of Forfeitures

Companies will need processes to meet Statement 123R's requirement to estimate the number of awards that will be forfeited. Under Statement 123 forfeitures can be reflected in compensation cost in the period they occur. If companies previously recognized share-based compensation cost in accordance with Statement 123, they must recognize in income at the date they adopt

Statement 123R a cumulative-effect adjustment of the change in accounting principle for the difference between compensation cost previously recognized using actual forfeitures and the compensation cost that would have been recognized using expected forfeitures. Companies that reported the Statement 123 information using the pro forma disclosure alternative must also compute a cumulative-effect amount to determine the compensation cost to recognize subsequent to the adoption of Statement 123R, as illustrated in the boxed-example.

Offsetting Tax Deficiencies

Companies need to determine whether they will have data-gathering difficulties when complying with Statement 123R's requirements for recognizing the tax effects of share-option awards, including the treatment in different tax jurisdictions. In many jurisdictions, the deductions are equal to the intrinsic value at the date the award is exercised.

Both Statement 123R and Statement 123 measure compensation cost for equity-classified share-based-payment awards using the grant-date fair value. If the tax deduction ultimately realized is greater than the compensation cost for financial-reporting purposes (a deferred

Example Adjusting Compensation Cost to Reflect Estimated Forfeitures

Case 1—Company A, a calendar-year company, granted equity-classified share options on January 1, 2004. The share options have a grant-date fair value of \$10,000 and will vest after four years of service. Company A will adopt Statement 123R on January 1, 2006. It now recognizes compensation cost in its income statement in accordance with Statement 123, recognizing forfeitures as they occur. As of December 31, 2005, no forfeitures have occurred. Based on its historical experience, Company A expects 10 percent of the awards to be forfeited prior to vesting.

In 2004 and 2005, Company A recognized compensation cost of \$2,500 ($\$10,000/4$ years). Had Company A recognized compensation

cost adjusted for estimated forfeitures, it would have recognized compensation cost of \$2,250 ($(\$10,000 - \$1,000 \text{ for estimated forfeitures}) / 4$ years). Cumulative compensation cost recognized for 2004—2005 is \$5,000. Cumulative compensation cost for 2004—2005 that would have been recognized if estimated forfeitures were reflected in compensation cost is \$4,500. Therefore, upon adoption of Statement 123R, Company A will include in its income statement a cumulative effect from the adoption of Statement 123R of \$500 ($\$5,000 - \$4,500$), ignoring tax effects. For 2006—2007 (assuming the actual forfeitures equal the 10 percent estimated forfeiture rate), compensation cost of \$2,250 would be recognized each year.

Case 2—Assume the same scenario described in Case 1 except that Company A reported compensation cost using pro forma disclosures in 2004—2005. For 2006—2007, Company A would recognize compensation cost of \$2,250 per year. Its comparative information for 2004 and 2005 (which would include the pro forma disclosures) would show compensation cost of \$2,500 per year. In this situation, Company A computes a cumulative-effect adjustment of \$500, ignoring tax effects. However, that amount is not reported in the company's financial statements. If the difference significantly affects the comparative information, Company A may need to explain the effects of estimated forfeitures in its MD&A or in the financial statements.

⁵ See illustrations 15 and 16, beginning at paragraphs A190 and A192, respectively.

tax asset is recognized for the tax benefit of the compensation cost for financial-reporting purposes for awards that ordinarily result in tax deductions), the excess creates a tax benefit that is included in additional paid-in capital. If the tax deduction is less than the compensation cost for financial-reporting purposes, the difference creates a deficiency because the actual tax benefit is less than the recognized deferred tax asset. Statement 123R requires companies to offset that tax deficiency against the additional paid-in capital from previous excess tax benefits. If additional paid-in capital from previous excess tax benefits is too small to absorb the entire tax deficiency, the remaining portion of the tax deficiency is recognized in the income statement in that period.

One potential difficulty in complying with these requirements lies in determining the amount of additional paid-in capital from previous excess tax benefits. Statement 123R limits the amount recorded at the time of adoption to the pool of excess tax benefits that was created or *would have* been created had Statement 123 been applied to recognize compensation cost for share-based payment since its effective date. For companies that reported Statement 123 amounts in pro forma disclosures rather than recognizing them as an expense in the income statement, the available pool of excess tax benefits is an unrecorded or hypothetical amount, the amount that would have resulted from applying Statement 123's compensation cost recognition provisions to awards granted in periods beginning after December 15, 1994.

The hypothetical amount will differ from the pool of excess tax benefits currently recorded as additional paid-in capital reported in the balance sheet for two reasons. First, most companies continued to apply the recognition provisions of Opinion 25. Second, companies have recorded additional paid-in capital from previous excess tax benefits for awards granted prior to 1995, periods before Statement 123's effective date. Thus, even companies that rec-

ognized Statement-123 amounts in the income statement may find that the pool of excess tax benefits differs from the recorded amounts.

This hypothetical amount of additional paid-in capital from previous excess tax benefits must be calculated using the tax effects of each award. The effort can be further complicated by business combinations accounted for as poolings of interests, spinoffs, and other transactions during the period from 1995 to 2005. The SEC staff, in SAB 107, points out that public companies that adopt Statement 123R using the modified-prospective method may not need to compute the hypothetical excess-tax-benefit amount until an actual tax deficiency arises in a period subsequent to the adoption of Statement 123R. However, a potential tax deficiency that would be recognized as an offset to the excess-tax-benefit amount must be considered in computing diluted earnings per share under Statement 128.⁶ For this reason, companies whose share options are in-the-money by an amount less than their grant-date fair value may need to compute the hypothetical excess-tax-benefit amount for the first quarter that Statement 123R is applied.

Effect of Compensation Strategies

Changes in the structure of a company's share-based awards can affect the application of Statement 123R. For example, changes in plan terms may affect future employee exercise behavior, thereby reducing the reliability of the company's historical experience in support of assumptions about the expected term of the awards.

Statement 123R will also change the way that current compensation strategies affect financial-statement amounts. Compensation strategies that previously resulted in more compensation cost than was recognized for fixed stock-option awards, such as nonvested stock grants and awards with performance vesting conditions, may no longer do so. For example, performance conditions in share-based-payment arrangements had led to variable-plan account-

ing under Opinion 25. Under Statement 123R, however, equity-classified awards with performance conditions are measured at the grant date, rather than at the vesting date, just as equity-classified awards with a service condition are. Share-based-payment awards with market conditions as incentives—say, for example, awards exercisable only if the company's stock price return exceeds those of its industry sector for a specified period of time—would introduce more complexity into the valuation than would awards with performance conditions.

Systems and Controls

Companies adopting Statement 123R should ensure that their procedures to value and account for their share-based-payment awards are effective, and they should document how they developed their valuation assumptions. Companies will also need to ensure that their systems include monitoring information and processes applied by third-party service providers. The services might include outsourcing of systems that help track share-based-payment awards, cash handling, and tax settlement when the awards are exercised.

Financial-reporting systems should properly record and classify the accounting consequences of share-based-payment plans. In particular, companies will need information to determine the tax effects of each award (including the amount of additional paid-in capital from previous excess tax benefits), the amount of tax benefit that is to be reported as a financing activity in the statement of cash flows, and the portion of compensation cost that is subject to capitalization.

After Statement 123R is adopted, some portion of the compensation cost will in many instances be capitalized in one period and recognized in the income statement in one or more subsequent periods. Compensation cost might, for example, represent activities attributable to the following accounts and therefore be capitalized:

- Inventory,

⁶ FASB Statement No. 128, *Earnings per Share*, February 1997, available at www.fasb.org.



- Self-constructed property, plant, and equipment,
- Loan origination fees and costs capitalized in accordance with Statement 91,⁷
- Deferred acquisition costs in the insurance industry,
- Computer software costs capitalized in compliance with Statement 86 or SOP 98-1,⁸
- Contract costs for arrangements accounted for in compliance with SOP 81-1,⁹
- Direct-response advertising costs capitalized in the limited situations described in SOP 93-7,¹⁰
- Mine development costs,
- Exploration costs capitalized in the oil and gas industry, and
- Goodwill or other assets acquired as a consequence of share options issued to effect a business combination.

Companies are not required to adjust their balance-sheet accounts for amounts that would have been capitalized on a pro forma basis when reporting pro forma net income information in accordance with Statement 123. However, because share-based-payment compensation cost must be reflected in the appropriate financial-statement line item, companies' systems should be designed to classify these costs in the appropriate balance-sheet account in the period that the related compensation cost is recognized and to recognize them in the income statement in the proper subsequent period. Since a temporary difference does not arise until the period in which compensation cost affects net income, this information will also be needed to recognize and derecognize the related deferred tax amounts.

SEC registrants, which must report on the effectiveness of their internal controls over financial reporting to comply with section 404 of the Sarbanes-Oxley Act, will need to assess the effectiveness of internal control over financial reporting related to accounting for share-based-payment arrangements.



The SEC delayed the effective date of Statement 123R for SEC registrants, giving many companies additional time to prepare to adopt the Statement.¹¹ The SEC's purposes were to give companies more time to prepare to adopt the Statement and to allow companies to adopt it as of the beginning of their fiscal year. Many companies would benefit from using the additional time to develop the necessary systems and to accumulate the necessary information on share-based payments.

The descriptive and summary statements above are not intended to substitute for the text of Statements 123R, 123, 128; APB Opinion 25; Staff Accounting Bulletin 107; or any of 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.

This is a publication of KPMG's
Department of Professional
Practice—Audit and Risk Advisory
212-909-5600

Contributing authors:

Paul H. Munter
James R. Calvert
Bruce R. F. Darton

Earlier editions are available at:
www.aro.kpmg.com

Defining Issues® is a registered trademark of KPMG LLP © 2001-2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative. All rights reserved. A16595NYGR

⁷ FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, December 1986, available at www.fasb.org.

⁸ FASB Statement No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed, August 1985, available at www.fasb.org; AICPA Statement of Position No. 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, March 1998.

⁹ AICPA Statement of Position No. 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, July 1981.

¹⁰ AICPA Statement of Position No. 93-7, Reporting on Advertising Costs, December 1993.

¹¹ 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 www.sec.gov.