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Financial Accounting Series

EXPOSURE DRAFT

Proposed Statement of Financial Accounting Standards

Share-Based Payment

an amendment of FASB Statements No. 123 and 95

This Exposure Draft of a proposed Statement of Financial Accounting Standards is issued by the Board for public comment. Written comments should be addressed to:

Director of Major Projects
File Reference No. 1102-100

Comment Deadline: June 30, 2004

Financial Accounting Standards Board
of the Financial Accounting Foundation

Responses from interested parties wishing to comment on the Exposure Draft must be *received* in writing by June 30, 2004. Interested parties should submit their comments by email to director@fasb.org, File Reference No. 1102-100. Those without email may send their comments to the "Director of Major Projects—File Reference No. 1102-100" at the address at the bottom of this page. Responses should *not* be sent by fax.

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Notice for Recipients of This Exposure Draft

This proposed Statement addresses the accounting for transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. This proposed Statement would eliminate the ability to account for share-based compensation transactions using APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and generally would require instead that such transactions be accounted for using a fair-value-based method.

This proposed Statement would neither change the accounting in FASB Statement No. 123, *Accounting for Stock-Based Compensation,* for transactions in which an enterprise exchanges its equity instruments for services of parties other than employees nor change the accounting for employee stock ownership plans, which are subject to AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans*. The Board intends to reconsider the accounting for those transactions and plans in a later phase of its project on equity-based compensation.

The Board invites comments on all matters in this proposed Statement, particularly on the specific issues discussed below. Respondents need not comment on all of the issues presented and are encouraged to comment on additional issues as well. It would be helpful if respondents comment on the issues as stated, include any alternatives the Board should consider, and explain the reasons for the positions taken. Where appropriate, it would be useful if respondents identified the specific paragraph or group of paragraphs to which their comments relate.

Recognition of Compensation Cost

Issue 1: The Board has reaffirmed the conclusion in Statement 123 that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations (refer to paragraphs C13–C15). Based on that conclusion, this proposed Statement requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusions? If not, please provide your alternative view and the basis for it.

Issue 2: Statement 123 permitted enterprises the option of continuing to use Opinion 25's intrinsic value method of accounting for share-based payments to employees provided those enterprises supplementally disclosed pro forma net income and related pro forma earnings per share information (if earnings per share is presented) as if the fair-value-based method of accounting had been used. For the reasons described in paragraphs C26–C30, the Board concluded that such pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements. Do you agree with that conclusion? If not, why not?

Measurement Attribute and Measurement Date

Issue 3: This proposed Statement would require that public companies measure the compensation cost related to employee services received in exchange for equity instruments issued based on the grant-date fair value of those instruments. Paragraphs C16–C19 and C53 explain why the Board believes fair value is the relevant measurement attribute and grant date is the relevant measurement date. Do you agree with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?

Fair Value Measurement

Issue 4(a): This proposed Statement indicates that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used to measure the fair value of equity and liability instruments awarded in share-based payment arrangements with employees. In the absence of an observable market price, this proposed Statement requires that the fair value of equity share options awarded to employees be estimated using an appropriate valuation technique that takes into consideration various factors, including (at a minimum) the exercise price of the option, the expected term of the option, the current price of the underlying share, the expected volatility of the underlying share price, the expected dividends on the underlying share, and the risk-free interest rate (paragraph 19 of Appendix A). Due to the absence of observable market prices, the fair value of most, if not all, share options issued to employees would be measured using an option-pricing model. Some constituents have expressed concern about the consistency and comparability of fair value estimates developed from such models. This proposed Statement elaborates on and expands the guidance in Statement 123 for developing the assumptions to be used in an option-pricing model (paragraphs B13–B30). Do you believe that this proposed Statement provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency? If not, what additional guidance is needed and why?

Issue 4(b): Some constituents assert that the fair value of employee share options cannot be measured with sufficient reliability for recognition in the financial statements. In making that assertion, they note that the Black-Scholes-Merton formula and similar closed-form models do not produce reasonable estimates of the fair value because they do not adequately take into account the unique characteristics of employee share options. For the reasons described in paragraphs C21–C25, the Board concluded that fair value can be measured with an option-pricing model with sufficient reliability. Board members agree, however, that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options—they believe that a lattice model (as defined in paragraph E1) is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. However, for the reasons noted in paragraph C24, the Board decided not to require the use of a lattice model at this time. Do you agree with the Board's conclusion that the fair value of employee share options can be measured with sufficient reliability? If not, why not? Do you agree with the Board's conclusion that a lattice model is preferable because it offers greater flexibility needed to reflect the unique characteristics of employee share options. If not, why not?

Issue 4(c): Some respondents to the Invitation to Comment suggested that the FASB prescribe a single method of estimating expected volatility or even a uniform volatility assumption that would be used for all companies. Other respondents to the Invitation to Comment disagreed with such an approach. Additionally, some parties believe that historical volatility, which has been commonly used as the estimate of expected volatility under Statement 123 as originally issued, is often not an appropriate measure to use. The proposed Statement would require enterprises to make their best estimate of expected volatility (as well as other assumptions) by applying the guidance provided in paragraphs B24–B26 to their specific facts and circumstances. In that regard, the proposed Statement provides guidance on information other than historical volatility that should be used in estimating expected volatility, and explicitly notes that defaulting to historical volatility as the estimate of expected volatility without taking into consideration other available information is not appropriate. If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

Issue 4(d): This proposed Statement provides guidance on how the unique characteristics of employee share options would be considered in estimating their grant-date fair value. For example, to take into account the nontransferability of employee share options, this proposed Statement would require that fair value be estimated using the expected term (which is determined by adjusting the option's contractual term for expected early exercise and post-vesting employment termination behaviors) rather than its contractual term. Moreover, the Board decided that compensation cost should be recognized only for those equity instruments that vest to take into account the risk of forfeiture due to vesting conditions. Do you agree that those methods give appropriate recognition to the unique characteristics of employee share options? If not, what alternative method would more accurately reflect the impact of those factors in estimating the option's fair value? Please provide the basis for your position.

Issue 5: In developing this proposed Statement, the Board acknowledged that there may be circumstances in which it is not possible to reasonably estimate the fair value of an equity instrument. In those cases, the Board decided to require that compensation cost be measured using an intrinsic value method with remeasurement through the settlement date (paragraphs 21 and 22 of Appendix A). Do you agree that the intrinsic value method with remeasurement through the settlement date is the appropriate alternative accounting treatment when it is not possible to reasonably estimate the fair value? (Refer to paragraphs C66 and C67 for the Board's reasons for selecting that method.) If not, what other alternative do you prefer, and why?

Employee Stock Purchase Plans

Issue 6: For the reasons described in paragraph C75, this proposed Statement establishes the principle that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares. Do you agree with that principle? If not, why not?

Attribution of Compensation Cost

Issue 7: This proposed Statement would require that compensation cost be recognized in the financial statements over the requisite service period, which is the period over which employee services are provided in exchange for the employer's equity instruments. Do you believe that the requisite service period is the appropriate basis for attribution? If not, what basis should be used?

Issue 8: Determining the requisite service period would require analysis of the terms and conditions of an award, particularly when the award contains more than one service, performance, or market condition. Paragraphs B37–B49 provide guidance on estimating the requisite service period. Do you believe that guidance to be sufficient? If not, how should it be expanded or clarified?

Issue 9: For the reasons described in paragraphs C89–C91, the Board concluded that this proposed Statement would require a single method of accruing compensation cost for awards with a graded vesting schedule. This proposed Statement considers an award with a graded vesting schedule to be in substance separate awards, each with a different fair value measurement and requisite service period, and would require that they be accounted for separately. That treatment results in a recognition pattern that attributes more compensation cost to early portions of the combined vesting period of an award and less compensation cost to later portions. Do you agree with that accounting treatment? If not, why not?

Modifications and Settlements

Issue 10: This proposed Statement establishes several principles that guide the accounting for modifications and settlements, including cancellations of awards of equity instruments (paragraph 35 of Appendix A). Paragraphs C96–C115 explain the factors considered by the Board in developing those principles and the related implementation guidance provided in Appendix B. Do you believe those principles are appropriate? If you believe that additional or different principles should apply to modification and settlement transactions, please describe those principles and how they would change the guidance provided in Appendix B.

Income Taxes

Issue 11: This proposed Statement changes the method of accounting for income tax effects established in Statement 123 as originally issued. Paragraphs 41–44 of Appendix A describe the proposed method of accounting for income tax effects and paragraphs C128–C138 describe the Board's rationale. That method also differs from the one required in International Financial Reporting Standard (IFRS) 2, *Share-based Payment*. Do you agree with the method of accounting for income taxes established by this proposed Statement? If not, what method (including the method established in IFRS 2) do you prefer, and why?

Disclosures

Issue 12: Because compensation cost would be recognized for share-based compensation transactions, the Board concluded that it was appropriate to reconsider and modify the information required to be disclosed for such transactions. The Board also decided to frame the disclosure requirements of this proposed Statement in terms of disclosure objectives (paragraph 46 of Appendix A). Those objectives are supplemented by related implementation guidance describing the minimum disclosures required to meet those objectives (paragraphs B191–B193). Do you believe that the disclosure objectives set forth in this proposed Statement are appropriate and complete? If not, what would you change and why? Do you believe that the minimum required disclosures are sufficient to meet those disclosure objectives? If not, what additional disclosures should be required? Please provide an example of any additional disclosure you would suggest.

Transition

Issue 13: This proposed Statement would require the modified prospective method of transition for public companies and would not permit retrospective application (paragraphs 20 and 21). The Board's rationale for that decision is discussed in paragraphs C157–C162. Do you agree with the transition provisions of this proposed Statement? If not, why not? Do you believe that entities should be permitted to elect retrospective application upon adoption of this proposed Statement? If so, why?

Nonpublic Entities

Issue 14(a): This proposed Statement would permit nonpublic entities to elect to use an intrinsic value method of accounting (with final measurement of compensation cost at the settlement date) rather than the fair-value-based method, which is preferable. Do you agree with the Board's conclusion to allow an intrinsic value method for nonpublic entities? If not, why not?

Issue 14(b): Consistent with its mission, when the Board developed this proposed Statement it evaluated whether it would fill a significant need and whether the costs imposed to apply this proposed Statement, as compared to other alternatives, would be justified in relation to the overall benefits of the resulting information. As part of that evaluation, the Board carefully considered the impact of this proposed Statement on nonpublic entities and made several decisions to mitigate the incremental costs those entities would incur in complying with its provisions. For example, the Board decided to permit those entities to elect to use either the fair-value-based method or the intrinsic value method (with final measurement of compensation cost at settlement date) of accounting for share-based compensation arrangements. Additionally, the Board selected transition provisions that it believes will minimize costs of transition (most nonpublic entities would use a prospective method of transition rather than the modified prospective method required for public entities). Moreover, the Board decided to extend the effective date of this proposed Statement for nonpublic entities to provide them additional time to study its requirements and plan for transition. Do you believe those decisions are appropriate? If not, why not? Should other modifications of this proposed Statement's provisions be made for those entities?

Small Business Issuers

Issue 15: Some argue that the cost-benefit considerations that led the Board to propose certain accounting alternatives for nonpublic entities should apply equally to small business issuers, as defined by the Securities Act of 1933 and the Securities Exchange Act of 1934. Do you believe that some or all of those alternatives should be extended to those public entities?

Cash Flows

Issue 16: For the reasons discussed in paragraphs C139–C143, the Board decided that this proposed Statement would amend FASB Statement No. 95, *Statement of Cash Flows,* to require that excess tax benefits, as defined by this proposed Statement, be reported as a financing cash inflow rather than as a reduction of taxes paid (paragraphs 17–19). Do you agree with reflecting those excess tax benefits as financing cash inflows? If not, why not?

Differences between This Proposed Statement and IFRS 2

Issue 17: Certain accounting treatments for share-based payment transactions with employees in this proposed Statement differ from those in IFRS 2, including the accounting for nonpublic enterprises, income tax effects, and certain modifications. Those differences are described more fully in Appendix C. If you prefer the accounting treatment accorded by IFRS 2, please identify the difference and provide the basis for your preference. If you prefer the accounting treatment in the proposed Statement, do you believe the Board nonetheless should consider adopting the accounting treatment prescribed in IFRS 2 in the interest of achieving convergence?

Understandability of This Proposed Statement

Issue 18: The Board's objective is to issue financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the accounting standard, and a willingness to study the standard with reasonable diligence. Do you believe that this proposed Statement, taken as a whole, achieves that objective?

Public Roundtable Meetings and Small Business Advisory Committee Meeting

The Board plans to hold several public roundtable meetings with constituents to discuss issues related to this proposed Statement. Those roundtable meetings tentatively are scheduled to take place around the end of the comment period in the San Francisco Bay area of California, and in Norwalk, Connecticut. The specific dates of the public roundtable meetings and instructions for constituents interested in participating in them will be announced in a future issue of FASB *Action Alert*. Each roundtable meeting can accommodate a limited number of participants. The Board plans to seek participants for each meeting that represent a wide variety of constituents including investors, preparers of financial statements, auditors, valuation experts, and others to ensure that it will receive input from diverse views. The Board also plans to discuss the views of constituents representing small and medium-sized businesses regarding this proposed Statement at the inaugural meeting of the Small Business Advisory Committee on May 11, 2004, in Norwalk, Connecticut.

Summary

This proposed Statement addresses the accounting for transactions in which an enterprise exchanges its valuable equity instruments for employee services. It also addresses transactions in which an enterprise incurs liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of those equity instruments in exchange for employee services. This proposed Statement does not change the accounting for similar transactions involving parties other than employees or the accounting for employee stock ownership plans, which are subject to AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans;* the Board intends to reconsider the accounting for those transactions and plans in a later phase of its project on equity-based compensation.

The objective of the accounting required by FASB Statement No. 123, *Accounting for Stock-Based Compensation,*[*] as it would be amended by this proposed Statement, is to recognize in an entity's financial statements the cost of employee services received in exchange for valuable equity instruments issued, and liabilities incurred, to employees in share-based payment transactions. Key provisions of this proposed Statement are as follows:

a. For public entities, the cost of employee services received in exchange for equity instruments would be measured based on the grant-date fair value of those instruments (with limited exceptions). That cost would be recognized over the requisite service period (often the vesting period). Generally, no compensation cost would be recognized for equity instruments that do not vest.

b. For public entities, the cost of employee services received in exchange for liabilities would be measured initially at the fair value of liabilities and would be remeasured subsequently at each reporting date through settlement date. The pro rata change in fair value during the requisite service period would be recognized over that period, and the change in fair value after the requisite service period is complete would be recognized in the financial statements in the period of change.

c. The grant-date fair value of employee share options and similar instruments would be estimated using option-pricing models adjusted for the unique characteristics of those options and instruments (unless observable market prices for the same or similar options are available).

d. If an equity award is modified subsequent to the grant date, incremental compensation cost would be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately prior to the modification.

e. Employee share purchase plans would not be considered compensatory if the terms of those plans were no more favorable than those available to all holders of the

[*]Unless the text indicates otherwise, all references to Statement 123 in this summary are to that Statement as originally issued—that is, before the effects of this amendment.

same class of shares and substantially all eligible employees could participate on an equitable basis.

f. Excess tax benefits, as defined by this proposed Statement, would be recognized as an addition to paid-in capital. Cash retained as a result of those excess tax benefits would be presented in the statement of cash flows as financing cash inflows. The write-off of deferred tax assets relating to unrealized tax benefits associated with recognized compensation cost would be reported as income tax expense.

g. This proposed Statement allows nonpublic entities to elect to measure compensation cost of awards of equity share options and similar instruments at intrinsic value through the date of settlement. That election also would apply to awards of liability instruments. This proposed Statement also requires that public entities measure compensation cost of awards of equity share options and similar instruments at intrinsic value through the date of settlement if it is not reasonably possible to estimate their grant-date fair value.

h. The notes to financial statements of both public and nonpublic entities would disclose the information that users of financial information need to understand the nature of share-based payment transactions and the effects of those transactions on the financial statements.

Background

APB Opinion No. 25, *Accounting for Stock Issued to Employees,* was issued in 1972. Opinion 25 required that compensation cost for awards of share options be measured at their intrinsic value, which is the amount by which the fair value of an equity share exceeds the exercise price. Opinion 25 also established criteria for determining the date at which an award's intrinsic value should be measured; that criteria distinguished between awards whose terms are known (or fixed) at the date of grant and awards whose terms are not known (or variable) at the date of grant. Measuring fixed awards' intrinsic values at the date of grant generally resulted in little or no compensation cost being recognized for valuable equity instruments given to employees in exchange for their services. Additionally, distinguishing between fixed and variable awards was difficult in practice, which resulted in a large amount of specialized and complex accounting guidance.[†]

Statement 123 was issued in 1995 and was effective for share-based compensation transactions occurring in fiscal periods beginning after December 15, 1995. As originally issued, Statement 123 established a fair-value-based method of accounting for share-based compensation awarded to employees. The fair-value-based method of accounting requires that compensation cost for awards of share options be measured at their fair value on the date of grant. As opposed to the accounting under Opinion 25, the application of the fair-value-based method to fixed awards results in compensation cost

[†]That guidance was identified by the United States Securities and Exchange Commission (SEC) as an example of rules-based accounting standards (SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System,* March 25, 2003 [www.sec.gov]).

being recognized when services are received in exchange for valuable equity instruments of the employer. Statement 123 established as preferable the fair-value-based method and encouraged, but did not require, entities to adopt it. The Board's decision at that time to permit entities to continue accounting for share-based compensation transactions using Opinion 25 was based on practical rather than conceptual considerations.

Reasons for Issuing This Proposed Statement

There are four principal reasons for issuing this proposed Statement:

a. **Addressing concerns of users and others.** Users of financial statements, including institutional and individual investors, as well as many other parties expressed to the FASB their concerns that using Opinion 25's intrinsic value method results in financial statements that do not faithfully represent the economic transactions affecting the issuer, namely, the receipt and consumption of employee services in exchange for valuable equity instruments. Financial statements that do not faithfully represent the economic transactions affecting an issuer can distort the reported financial condition and operations of that issuer and can lead to the inappropriate allocation of resources. Part of the FASB's mission is to improve standards of financial accounting for the benefit of users of financial information.

b. **Improving the comparability of reported financial information through the elimination of alternative accounting methods.** During the summer of 2002, a number of public companies announced their intention of voluntarily adopting Statement 123's fair-value-based method of accounting for share-based compensation transactions with employees. Since then, approximately 500 public companies have voluntarily adopted or announced their intention to adopt the fair-value-based method. Despite the many public companies that have voluntarily adopted the fair-value-based method of accounting, there remains a large number of companies that continue to use Opinion 25's intrinsic value method. The Board believes that similar economic transactions should be accounted for similarly (that is, share-based compensation transactions with employees should be accounted for using one method). Consistent with the conclusion in Statement 123, the Board believes such transactions should be accounted for using the fair-value-based method.

c. **Simplifying U.S. GAAP.** This proposed Statement would simplify the accounting for share-based payments. The Board believes that U.S. GAAP should be simplified whenever possible. Requiring the use of a single method of accounting for share-based payment would result in the elimination of Opinion 25's intrinsic value method and the many related detailed and form-driven rules.

d. **International convergence.** This proposed Statement would result in greater international comparability in the accounting for share-based payment. In February 2004, the International Accounting Standards Board (IASB), whose standards are followed by enterprises in many countries throughout the world, issued International Financial Reporting Standard (IFRS) 2, *Share-based Payment*.

IFRS 2 requires that all enterprises recognize an expense for all employee services received (and consumed) in exchange for the enterprise's equity instruments. The IASB concluded that share-based compensation transactions should be accounted for using a fair-value-based method that is similar in most respects to the fair-value-based method established in this proposed Statement. Converging to a common set of high-quality financial accounting standards on an international basis for share-based payment transactions with employees improves the comparability of financial information around the world and simplifies the accounting for enterprises that report financial statements under both U.S. GAAP and international accounting standards.

The Board believes that this proposed Statement addresses users' and other parties' concerns by requiring enterprises to recognize an expense in the income statement for employee services received (and consumed) in exchange for the enterprises' equity instruments, thereby reflecting the consequences of the economic transaction in the financial statements. By requiring the fair-value-based method for all public companies, this proposed Statement would eliminate an alternative accounting method and the accounting guidance associated with that method; consequently, similar economic transactions would be accounted for similarly. Finally, requiring the use of Statement 123's fair-value-based method is convergent with IFRS 2.

Differences between This Proposed Statement and Current Practice

This proposed Statement would affect current practice in a number of ways, but chief among them is that it would eliminate the alternative to use Opinion 25's intrinsic value method of accounting that was provided in Statement 123 as originally issued. Under Opinion 25, issuing stock options to employees generally resulted in recognition of no compensation cost. This proposed Statement would require public companies to recognize the cost of employee services received in exchange for equity instruments, based on the grant-date fair value of those instruments (with limited exceptions).

This proposed Statement would affect current practice in other ways, including the measurement attribute for nonpublic entities, the pattern in which compensation cost would be recognized, the accounting for employee share purchase plans, and the accounting for income tax effects of share-based payment transactions. Paragraphs 6–15 of this proposed Statement summarize those as well as other differences.

How This Proposed Statement Would Improve Financial Reporting

This proposed Statement would require the recognition of compensation cost incurred as a result of receiving employee services in exchange for valuable equity instruments issued by the employer. Recognizing compensation cost in the financial statements improves the relevance and reliability of that financial information, helping users of financial information to understand better the economic transactions affecting an enterprise and to make better resource allocation decisions. Such information specifically will help users of financial statements understand the impact that share-based compensation arrangements have on an enterprise's financial condition and operations. This proposed Statement also would improve comparability by eliminating one of two different methods of accounting for share-based compensation transactions and would also thereby simplify existing U.S. GAAP. Eliminating different methods of accounting for the same transactions leads to improved comparability of financial statements because similar economic transactions are accounted for similarly.

How the Conclusions in This Proposed Statement Relate to the FASB's Conceptual Framework

FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises,* states that financial reporting should provide information that is useful in making business and economic decisions. Recognizing compensation cost incurred as a result of receiving employee services in exchange for valuable equity instruments issued by the employer will help achieve that objective by providing information about the costs incurred by the employer to obtain employee services in the marketplace.

With respect to the notion of *comparability,* FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information,* states that information about an enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises. Establishing the fair-value-based method of accounting as the required method will increase comparability because similar economic transactions will be accounted for similarly. That will improve the usefulness of financial information. Neutrality is another important characteristic of accounting information. Establishing that method also eliminates the accounting bias toward using employee share options for compensation, which results in accounting that is neutral for different forms of compensation.

Completeness is identified in Concepts Statement 2 as an essential element of representational faithfulness and relevance. Thus, to faithfully represent the total cost of employee services to the enterprise, compensation cost relating to valuable equity instruments issued by the employer to its employees in exchange for their services should be recognized in the employer's financial statements.

Concepts Statement 6 defines *assets* as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. Employee services cannot be stored and are received and used simultaneously. Those employee services are assets of an enterprise only momentarily—as the entity receives and uses them—although their use may create or add value to other assets of the enterprise. When an employer exchanges its valuable equity instruments for employee services, the receipt of those employee services creates an asset that should be either capitalized as part of another asset of the enterprise (as permitted by U.S. GAAP) or expensed when consumed.

Costs and Benefits

The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. The Board's consideration of each issue in a project includes the subjective weighing of the incremental improvement in financial reporting against the incremental cost of implementing the identified alternatives. At the end of that process, the Board considers the accounting provisions in the aggregate and assesses the related perceived costs on a qualitative basis.

Several procedures were conducted before the issuance of this proposed Statement to aid the Board in its assessment of the expected costs associated with implementing the required use of the fair-value-based accounting method. Those procedures included a field visit program, a survey of commercial software providers, and discussions with Option Valuation Group members, valuation experts, compensation consultants, and numerous other constituents. Based on the findings of those cost-benefit procedures, the Board concluded that this proposed Statement will sufficiently improve financial reporting to justify the costs it will impose. Paragraphs C40–C47 provide a discussion of the Board's cost-benefit assessment with respect to this proposed Statement.

The Effective Dates of This Proposed Statement

This proposed Statement would be applied to public entities prospectively for fiscal years beginning after December 15, 2004, as if all share-based compensation awards granted, modified, or settled after December 15, 1994, had been accounted for using the fair-value-based method of accounting. Nonpublic entities that had adopted the fair-value-based method of accounting for recognition or pro forma disclosures would use the same transition and effective date as public entities. All other nonpublic entities would apply this proposed Statement prospectively for fiscal years beginning after December 15, 2005.

Proposed Statement of Financial Accounting Standards

Share-Based Payment

an amendment of FASB Statements No. 123 and 95

March 31, 2004

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Proposed Statement of Financial Accounting Standards

Share-Based Payment

an amendment of FASB Statements No. 123 and 95

March 31, 2004

INTRODUCTION

1. FASB Statement No. 123, *Accounting for Stock-Based Compensation*, was issued in October 1995. It requires that all **share-based payment (or compensation) arrangements**[1] with parties other than **employees** be accounted for based on their **fair value.** As originally issued, Statement 123 established as preferred a fair-value-based method of accounting for share-based payment arrangements with employees, but it permitted the continued use of APB Opinion No. 25, *Accounting for Stock Issued to Employees*. The accounting under Opinion 25 often resulted in recognition of no compensation cost for **share options** and similar instruments.

2. In response to concerns about the impaired usefulness and transparency of financial reporting resulting from the continued use of Opinion 25, and consistent with its commitment to the convergence of international accounting standards, the Board added a project to its agenda in March 2003 to reconsider Statement 123. This Statement, which addresses share-based payment arrangements with employees (other than **employee stock ownership plans**), is the result of the first phase of that project. The Board expects to reconsider certain aspects of the accounting for both share-based payment arrangements with parties other than employees and employee stock ownership plans in a later phase of this project.

3. This Statement also amends FASB Statement No. 95, *Statement of Cash Flows,* to require that **excess tax benefits** be reported as a financing cash inflow rather than as a reduction of taxes paid. As originally issued, Statement 95 required all income tax payments to be classified as operating cash outflows.

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[1]Terms defined in Appendix E, the glossary, are set in **boldface type** the first time they appear.

In addition to substantive amendments, this Statement also makes certain changes to the terminology used in Statement 123. Many of those changes conform to the terminology that the International Accounting Standards Board (IASB) uses in International Financial Reporting Standard (IFRS) 2, *Share-based Payment.* For example, this Statement refers to *share-based payment* rather than *stock-based compensation. Payment* and *compensation* have the same meaning in this Statement, and the terms are used interchangeably.

4. Appendix A contains a copy of paragraphs 1–50 of Statement 123 marked to indicate the amendments made by this Statement.[2] Appendix B, which is an integral part of this Statement, provides implementation guidance on measurement and recognition of compensation cost resulting from share-based payment arrangements with employees. It replaces Appendix B of Statement 123. Appendix C provides background information and the basis for the Board's conclusions. Appendix D provides amendments to existing pronouncements other than Statement 123, and Appendix G indicates the effect of this Statement on Emerging Issues Task Force (EITF) Issues and Statement 133 Implementation Issues. Appendix E defines certain terms as they are used in this Statement; it replaces Appendix E of Statement 123. Appendix F provides a clean copy of paragraphs 1–50 of Statement 123 that incorporates the amendments made by this Statement.

OVERVIEW OF SIGNIFICANT AMENDMENTS TO STATEMENT 123

Elimination of the Alternative of Continuing to Use Opinion 25's Intrinsic Value Method

5. The objective of the accounting required by Statement 123[3] as amended by this Statement is to recognize in an entity's financial statements the cost of employee services received in exchange for equity instruments issued, and liabilities incurred, to employees in **share-based payment (or compensation) transactions.** This Statement eliminates the alternative of continuing to account for share-based payment arrangements with employees under Opinion 25 and requires that the compensation cost resulting from all share-based payment transactions be recognized in the financial statements. This Statement also prospectively eliminates Statement 123's requirement for pro forma disclosures of the effect of applying the fair-value-based accounting method.

Measurement of Compensation Cost from Share-Based Payment Arrangements with Employees

Guidance on Estimating the Fair Value of Equity Share Options and Other Equity Instruments

6. This Statement retains the principle established in Statement 123 that a **public entity** should measure the cost of employee services received in exchange for awards of equity instruments based on the fair value of the instruments at the grant date. However,

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[2]Statement 123 was amended by FASB Statements No. 141, *Business Combinations,* No. 128, *Earnings per Share,* and No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections;* those amendments already have been reflected in the version of Statement 123 on which the amendments made by this Statement are marked. Amendments made to paragraphs 44 and 45 of Statement 123 by FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure,* are not reflected because this Statement deletes or replaces those paragraphs in their entirety.

[3]References to Statement 123 throughout paragraphs 5–15 are to that Statement as originally issued—that is, before the effects of this amendment.

this Statement elaborates on and clarifies the guidance in Statement 123 about using valuation techniques to estimate the fair value of equity share options and other equity instruments awarded to employees. Appendix B of this Statement explains that a better estimate of the fair value of an employee share option may be obtained by using a **lattice model** that incorporates employees' expected exercise and expected post-vesting employment termination behavior than by using a **closed-form model** (such as the Black-Scholes-Merton formula) with a single weighted-average expected option term as an input.

Requirements for a Nonpublic Entity's Awards of Equity Share Options

7. Statement 123 permitted a **nonpublic entity** to use the minimum value method to measure the cost of employee services received in exchange for awards of equity share options. This Statement does not permit use of the minimum value method as a substitute for the fair-value-based method. A nonpublic entity must make a policy decision of whether to measure compensation cost resulting from equity share options based on (a) their fair value at the grant date or (b) their **intrinsic value** at each reporting date until the options are exercised or otherwise **settled.**

Measurement of Liabilities

8. This Statement amends Statement 123's measurement requirements for liabilities incurred under share-based payment arrangements with employees. A public entity is required to measure those liabilities at fair value rather than at intrinsic value as required by Statement 123. A nonpublic entity must use the same measurement method—either fair-value-based or intrinsic value—for its liability awards that it uses for its equity share option awards.

Employee Share Purchase Plans

9. This Statement revises Statement 123's criteria for determining whether an employee share purchase plan may be considered noncompensatory. Such a plan may be considered noncompensatory only if (a) its terms are no more favorable than those available to all holders of the same class of shares and (b) substantially all eligible employees that meet limited employment qualifications may participate on an equitable basis.

Attribution of Compensation Cost

10. This Statement carries forward a variation of grant-date accounting (referred to as modified grant-date accounting) under which compensation cost is recognized only for instruments for which the **requisite service** is rendered (that is, for which the **requisite service period** is completed). This Statement requires an entity to base its accruals of compensation cost on the number of instruments for which the requisite service is expected to be rendered and to adjust that estimate if the actual number of instruments is expected to differ from previous estimates. It eliminates the alternative allowed under Statement 123 of recognizing compensation cost as if all instruments subject only to a service condition were expected to vest and recognizing forfeitures only as they occur.

11. Statement 123 provided alternative methods of measuring and recognizing compensation cost for awards with graded vesting—that is, awards for which different parts vest at different times. This Statement requires a single method under which those different parts are treated as separate awards in estimating fair value and attributing compensation cost.

Modifications and Cancellations

12. This Statement amends Statement 123 to require that the incremental compensation cost resulting from a **modification** of an award be measured as the excess of the fair value of the modified award over the fair value of the original award immediately before the modification. Modifications of equity awards rarely, if ever, will result in recognized compensation cost that is less than the fair value of the original award at the grant date unless the original service or performance vesting conditions are not expected to be satisfied at the modification date.

13. This Statement also establishes additional guidance on accounting for modifications and cancellations of awards. For example, this Statement specifies that a cancellation of an award accompanied by the grant of a **replacement award** is to be accounted for as a modification of the terms of the cancelled award. All other cancellations of awards are to be accounted for as repurchases for no consideration with no reduction in compensation cost.

Determining Whether Certain Instruments Are Liabilities or Equity

14. When Statement 123 was issued, determining whether a financial instrument should be classified as a liability or as equity depended almost entirely[4] on whether the instrument called for settlement by a transfer of assets (a liability) or an issuance of the entity's own equity instruments (equity). FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,* issued in May 2003, requires certain obligations that call for settlement by issuing an entity's own equity instruments to be classified as liabilities. This Statement amends Statement 123 to require that the classification criteria in Statement 150, as they are effective at the reporting date, be applied in determining whether an instrument granted to an employee is a liability or equity. This Statement also provides guidance for determining when certain instruments issued to employees as compensation subsequently become subject to Statement 150.

Recognition of Income Tax Effects of Share-Based Compensation

15. If the deductible compensation cost for an individual employee's equity instruments on the employer's tax return is less than the cumulative compensation cost recognized for those instruments for financial reporting purposes, this Statement requires that the write-off of the portion of the deferred tax asset related to that deficiency, net of the related

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[4]Although obligations issued in the form of equity shares but requiring cash settlement, such as mandatorily redeemable shares, qualified conceptually as liabilities before the issuance of Statement 150, U.S. GAAP had not necessarily required those instruments to be classified as liabilities in the financial statements.

valuation allowance, if any, be recognized in the income statement. For the period that the deductible compensation cost for income tax purposes is determined, Statement 123 reflected a portfolio rather than an individual-employee-instrument approach and thus required that that deficiency be charged to additional paid-in capital to the extent of any recognized excess tax benefits that arose from previous awards accounted for using the fair-value-based method. This Statement also amends Statement 123 to provide guidance on accounting for the income tax effects of liability awards. The cumulative amount of compensation cost recognized for a liability award that ordinarily results in a future tax deduction under existing tax law is considered a deductible temporary difference. The deductible temporary difference will be based on the fair value of the award.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to Statement 123

16. Paragraphs 1–50 of Statement 123 are amended to read as indicated in the marked copy that appears in Appendix A of this Statement. In addition, Appendix B of this Statement replaces Appendix B of Statement 123, and Appendix E of this Statement replaces Appendix E of Statement 123. Appendix F of Statement 123 is deleted.

Amendments to Statement 95

17. Paragraph 19 of Statement 95, as amended by FASB Statements No. 117, *Financial Statements of Not-for-Profit Organizations,* and No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities,* is amended as follows:

> Cash inflows from financing activities are:
>
> a. Proceeds from issuing equity instruments
> b. Proceeds from issuing bonds, mortgages, notes, and from other short- or long-term borrowing
> c. Receipts from contributions and investment income that by donor stipulation are restricted for the purposes of acquiring, constructing, or improving property, plant, equipment, or other long-lived assets or establishing or increasing a permanent endowment or term endowment
> d. Proceeds received[*] from derivative instruments that include financing elements[†] at inception
> <u>e.</u> <u>Cash retained as a result of the tax deductibility of increases in the value of equity instruments issued to parties under share-based payment arrangements that are not included in compensation cost recognizable for financial reporting purposes.</u>

[*] Whether at inception or over the term of the derivative instrument.

[†] Other than a financing element inherently included in an at-the-market derivative instrument with no prepayments.

18. Paragraph 23 of Statement 95, as amended by FASB Statements No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale,* and No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections,* is amended as follows:

> Cash outflows for operating activities are:
>
> a. Cash payments to acquire materials for manufacture or goods* for resale, including principal payments on accounts and both short- and long-term notes payable to suppliers for those materials or goods
> b. Cash payments to other suppliers and employees for other goods or services
> c. Cash payments to governments for taxes, duties, fines, and other fees or penalties <u>and the cash that would have been paid for income taxes if increases in the value of equity instruments issued to parties under share-based payment arrangements that are not recognizable as compensation cost for financial reporting purposes also had not been deductible in determining taxable income (This is the same amount reported as a financing cash inflow pursuant to paragraph 19(e) of this Statement.)</u>
> d. Cash payments to lenders and other creditors for interest
> e. All other cash payments that do not stem from transactions defined as investing or financing activities, such as payments to settle lawsuits, cash contributions to charities, and cash refunds to customers.
>
> *The term *goods* includes certain loans and other debt and equity instruments of other enterprises that are acquired specifically for resale, as discussed in Statement 102, and securities that are classified as trading securities as discussed in Statement 115.

19. Paragraph 27 of Statement 95, as amended by Statement 117, is amended as follows:

> In reporting cash flows from operating activities, enterprises are encouraged to report major classes of gross cash receipts and gross cash payments and their arithmetic sum—the net cash flow from operating activities (the direct method). Enterprises that do so should, at a minimum, separately report the following classes of operating cash receipts and payments:[11]
>
> a. Cash collected from customers, including lessees, licensees, and the like
> b. Interest and dividends received*
> c. Other operating cash receipts, if any
> d. Cash paid to employees and other suppliers of goods or services, including suppliers of insurance, advertising, and the like
> e. Interest paid
> f. Income taxes paid <u>and, separately, the cash that would have been paid for income taxes if increases in the value of equity instruments issued to parties under share-based payment arrangements that are not recognizable as</u>

compensation cost for financial reporting purposes also had not been deductible in determining taxable income

g. Other operating cash payments, if any.

Enterprises are encouraged to provide further breakdowns of operating cash receipts and payments that they consider meaningful and feasible. For example, a retailer or manufacturer might decide to further divide cash paid to employees and other suppliers (category (d) above) into payments for costs of inventory and payments for selling, general, and administrative expenses.

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[11]Paragraphs 115–118 in Appendix B and paragraph 135 in Appendix C, respectively, discuss and illustrate a method by which those major classes of gross operating cash receipts and payments generally may be determined indirectly.

*Interest and dividends that are donor restricted for long-term purposes as noted in paragraphs 18 and 19(c) are not part of operating cash receipts.

Effective Dates and Transition

20. This Statement shall be effective for awards that are granted, modified, or settled in fiscal years beginning after (a) December 15, 2004, for public entities and nonpublic entities that used the fair-value-based method of accounting under the original provisions of Statement 123 for recognition or pro forma disclosure purposes and (b) December 15, 2005, for all other nonpublic entities. Earlier application is encouraged provided that financial statements for those earlier years have not yet been issued. Retrospective application of this Statement is not permitted.

21. Public entities and nonpublic entities that used the fair-value-based method of accounting under the original provisions of Statement 123 for recognition or pro forma disclosure purposes also shall apply the provisions of this Statement in recognizing compensation cost for any portion of awards granted or modified after December 15, 1994, that is not yet vested at the date this Statement is adopted. Measurement and attribution of compensation cost for those earlier awards for fiscal years beginning after initial adoption of this Statement shall be based on the same estimate of the grant-date fair value and the same attribution method used previously for either (a) recognition or (b) pro forma disclosures under the original provisions of Statement 123. Any unearned or deferred compensation (contra-equity accounts) related to those earlier awards shall be eliminated against the appropriate equity accounts. Deferred tax balances for those earlier awards (and vested but not yet exercised awards) that continue to be classified as equity instruments under this Statement shall not be adjusted upon transition but shall be accounted for prospectively in accordance with Statement 123, as amended by this Statement. However, for purposes of calculating the excess tax benefit, an entity shall take into account all compensation cost recognized under Opinion 25, Statement 123, and Statement 123 as amended by this Statement.

22. Nonpublic entities that used the minimum value method of measuring share options and similar instruments for either recognition or pro forma disclosure purposes shall

apply this Statement prospectively and shall not apply it to the nonvested portion of awards outstanding at the date of initial application.

23. Transition for an instrument that was classified as equity but is classified as a liability as of the date this Statement is first applied shall be achieved by recognizing a reduction of additional paid-in capital to the extent of previously recognized compensation cost for the instrument and an increase to the liability. If the estimated fair value of the liability on the date this Statement is first applied exceeds the previously recognized compensation cost, that excess liability shall be recognized and the offsetting amount, net of any related tax effect, shall be recognized in the income statement as the cumulative effect of a change in accounting principle. For an outstanding instrument that previously was classified as a liability (and will continue to be accounted for as a liability under this Statement) and previously was measured at intrinsic value, a public entity (or a nonpublic entity that chooses the fair-value-based method) shall recognize as the cumulative effect of a change in accounting principle, net of any related tax effect, the effect of initially measuring the liability at its fair value.

24. In the year that this Statement is first applied, an entity shall disclose the effect of the change from applying the original provisions of Statement 123[5] on income from continuing operations, income before income taxes, net income, cash flow from operations, and basic and diluted earnings per share. In addition, if awards under share-based payment arrangements with employees are accounted for under the intrinsic value method of Opinion 25 for any reporting period for which an income statement is presented, a public entity shall continue to provide the tabular presentation of the following information that was required by paragraph 45 of Statement 123, as amended by FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure,* and paragraph 30 of APB Opinion No. 28, *Interim Financial Reporting,* as amended by Statement 148, for all those periods:

a. Net income and basic and diluted earnings per share as reported
b. The share-based employee compensation cost, net of related tax effects, included in net income as reported
c. The share-based employee compensation cost, net of related tax effects, that would have been included in net income if the fair-value-based method had been applied to all awards[6]
d. Pro forma net income as if the fair-value-based method had been applied to all awards
e. Pro forma basic and diluted earnings per share as if the fair-value-based method had been applied to all awards.

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[5]The effect of the change in the year this Statement is first applied will differ depending on whether a public entity had previously adopted the fair-value-based method (or a nonpublic entity had adopted the minimum value method) of Statement 123 or had continued to use the intrinsic value method in Opinion 25.

[6]For paragraphs 24(c)–24(e), *all awards* refers to awards granted, modified, or settled in fiscal periods beginning after December 15, 1994.

The required pro forma amounts shall reflect the difference in share-based employee compensation cost, if any, included in net income and the total cost measured by the fair-value-based method, as well as additional tax effects, if any, that would have been recognized in the income statement if the fair-value-based method had been applied to all awards. The required pro forma per-share amounts shall reflect the change in the denominator of the diluted earnings per share calculation as if the assumed proceeds under the treasury stock method, including measured but unrecognized compensation cost and any excess tax benefits credited to additional paid-in capital, were determined under the fair-value-based method.

25. A nonpublic entity that used the minimum value method for pro forma disclosure purposes under the original provisions of Statement 123 shall not continue to provide those pro forma disclosures for outstanding awards accounted for under the intrinsic value method of Opinion 25.

The provisions of this Statement need not be applied to immaterial items.