

# defining issues<sup>TM</sup>

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## Revisiting Stock-Option Accounting

The FASB will revisit stock-option accounting, seemingly committed to convergence with the coming international accounting standard on the same subject. These circumstances mean that the potential outcome could be a requirement to expense stock options based on their fair value. In that case, the financial-statement effect would depend on which approach to expensing the FASB adopts, because different approaches can yield different results and Statement 123's differs from the IASB exposure draft's.<sup>1</sup>

Those who want to understand the potential changes in accounting for stock-based compensation will need some grounding in the IASB's exposure draft. This edition of *Defining Issues* is therefore devoted to explaining the FASB's course of action, the main provisions of the IASB's document, and what they could mean for the FASB's new project.

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(1) FASB Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, October 1995, which permits a company to disclose the fair value effect of expensing stock awards in lieu of recognition; International Accounting Standards Board, (IASB) ED 2 Share-based Payment, November 18, 2002. The ED's comment period ended on March 7, 2003. KPMG submitted its response on March 7, 2003.

## “We need to put pedal to the metal along with the International Accounting Standards Board on this issue.”

—Robert H. Herz, FASB Chairman, March 12, 2003, at a Board meeting

### SUBSTANTIAL GROUNDWORK IS DONE

The terms of the FASB agenda project adopted in March of 2003 include an explicit commitment to maximum convergence with the coming international accounting standard on stock-based compensation. This means the IASB’s exposure draft that would mandate expensing will influence the outcome of the FASB’s project.

The questions in the FASB’s 2002 Invitation to Comment omitted whether expensing should be required, focusing instead on the differences between Statement 123 and the IASB exposure draft.<sup>2</sup>

Unprompted arguments opposed to expensing were submitted nevertheless by a majority of the 293 respondents, but the FASB’s initial analysis characterized them as the same reasoning that was considered when Statement 123 was issued. This suggests that the FASB believes no new evidence was submitted to change its earlier conclusion that expensing stock-based compensation using the fair-value method is a preferable method of accounting.

The IASB’s project is far along, a fact that will affect the FASB’s progress if the FASB keeps to its announced plan to issue its standard at the same time the IASB issues its final standard. The IASB’s exposure draft was issued in November 2002. The comment period ended March 7, 2003, and the IASB has committed to complete its standard by the end of 2003. No IASB standards now provide guidance on recognizing or measuring share-based awards to employees. Unlike the FASB, the IASB is addressing a gap, not reconsidering guidance already in place. This gives the IASB an incentive to move its project ahead swiftly.

(2) FASB, Invitation to Comment, Accounting for Stock-Based Compensation, November 2002, which solicited comments on certain issues for the FASB to discuss when considering whether to propose any changes to the U.S. accounting standards on stock-based compensation. The comment period ended on February 1, 2003. KPMG submitted its response on January 30, 2003, with a follow-up letter dated March 7, 2003.

### CONVERGENCE

The FASB said it will work with the IASB toward a converged standard. Convergence has meant reducing differences among standards applied in different countries. The focus here is much more narrow. In this case, convergence means reducing differences in stock-based compensation accounting between countries that will use the forthcoming IASB standard and those that follow U.S. GAAP.

It is impossible to know whether convergence will mean the FASB’s and IASB’s standards on stock-based compensation will more closely resemble the Statement 123 approach or the IASB’s approach, or whether convergence will be more a matter of general principles than of detailed requirements. The IASB’s commitment to

compromise is unexpressed at this point; it has other national constituents; and its due process on this project has advanced beyond the exposure-draft stage.

The key question for the FASB’s constituents is the relationship between the commitment to convergence and the quality of the accounting requirements to be added to U.S. GAAP. Convergence with the IASB’s standard in the tight timeframe created by the IASB’s current deadline should not mean that due process is given cursory attention or that problems go unaddressed. Although stock-option accounting has been heavily debated, the differences among approaches for expensing need full consideration in order to determine which best serves the users of financial statements. The overriding criterion should be the quality of the standard developed.

#### Constituents’ Responses to FASB Invitation to Comment

- Of the 293 respondents, 69% were from industry, 10% were users, 5% were public accountants, and the remaining 16% included compensation and valuation experts, academics, attorneys, and government officials.
- Based on unprompted responses from most respondents: 69% opposed mandatory expensing; 26% favored it. Eighty-eight percent of the respondents from industry opposed mandatory expensing; 76% of respondents that are users favored it.
- A majority of respondents generally favors Statement 123’s modified grant-date measurement method because they support the notion of issuance (i.e., the issuance date occurs when all consideration is exchanged). A majority of respondents believe that Statement 123’s attribution method better reflects the economics of stock-based compensation transactions. (Based on comment letters responding to specific questions raised by the Invitation to Comment.)
- The FASB staff found evidence that respondents do not prefer the basic approach to accounting for stock-based compensation in the proposed IASB standard.

\* Information from FASB, Board Meeting Handout, March 12, 2003.

## THE IASB EXPOSURE DRAFT—A GRANT-DATE, FAIR-VALUE ACCOUNTING MODEL

The IASB proposes to measure the fair value of the options at the date they are granted and to recognize that value as compensation cost in units of service over the period that service is received for the awards, which is usually the vesting period. Using the grant date for measurement has conceptual simplicity in its favor. It assumes the value of the goods or services received by the company is equal to the value of the consideration (the stock options) granted in exchange. The company applying the accounting model would estimate the fair value of the option only once during the life of the option. However, there are trade-offs for the model's conceptual simplicity.

The fair value of an option is reduced at grant date for estimated future forfeitures.<sup>3</sup> Fair value is not adjusted if actual forfeitures differ from the estimate made at grant date, although the compensation cost will reflect the units of service actually received.

Subsequent experience with forfeitures could be above or below the original estimate. However, the change in experience does not affect the fair value at the grant date, but does affect compensation expense to some degree through the units-of-service measurement described below.

The IASB approach is fundamentally different from Statement 123's "modified" grant-date model. Under Statement 123, the fair value of the option at grant date does not reflect estimated forfeitures. Instead, the expense that is recorded over the service period based on that initial measure of fair value is reduced for actual forfeitures of unvested options. Unlike Statement 123, the compensation expense recognized in earnings under the IASB proposal would not be reversed in subsequent periods to reflect actual shares or options that lapse or are forfeited, for example, because of failure to meet the vesting or performance

conditions that must be achieved for the grantee to receive the award. Thus, the IASB model is considered a pure grant-date model, because the fair value determined at the grant date is not adjusted for subsequent experience. This may appear contrary to the economics of transactions in which the share-based payments are awarded on an "all or nothing" basis rather than vesting on a pro rata basis.

**Variability of Fair Value.** Like other accounting estimates, the fair value of stock-based compensation is subject to significant variability based on a valid range of possible assumptions. The measurement of similar transactions may vary considerably

from entity to entity based on differences in judgment. The IASB fair-value approach differs from the Statement 123 fair-value approach and is more difficult to apply because it requires estimates of future performance by both the entity and the individuals being compensated at the grant date.

**"[T]here's an expense associated with options, [and] that expense ought to be reflected in the operating statements of the company. The devil is in the details as to how you do it."**

*—William H. Donaldson, Chairman of the SEC, February 5, 2003, Hearing of the Senate Banking, Housing and Urban Affairs Committee*

Measuring fair value at grant date under the IASB model calls for estimates of expected performance, such as the number of continuing employees, timing of terminations, and achievement of performance goals, such as earnings-per-share targets, stock-price targets, and revenue growth. This means similar compensation packages might be measured at different amounts because of different estimates that need to be fixed at grant date. Management's expectation of performance may not coincide with actual performance, because of the degree of difficulty in predicting turnover levels among the recipients of the awards or in predicting the outcome of achieving performance targets.

For example, assume Company A estimates forfeitures of 5 percent at date of grant, and Company B estimates forfeitures of 10 percent at date of grant. Subsequently, both companies receive an identical amount of employee services, and the

(3) For simplicity, this exposition is framed in terms of awards that will be settled with equity instruments. However under the IASB exposure draft the cumulative expense for a cash-settled award (e.g., a stock appreciation right) is based on the ultimate settlement amount (i.e., the cash paid).

employees receive identical stock awards. The compensation expense recorded by Company A will differ from the amount recorded by Company B because of the different grant-date estimates of departing employees.

## OPTION-PRICING MODELS

The IASB's proposal does not require a specific method for determining the fair value of granted stock options, but it mentions that the binomial and Black-Scholes valuation models can be used. It makes sense both to use effective option-pricing models to determine the fair value of options granted and not to prescribe the models to be used.

There is already evidence that option-pricing models produce significantly different results, which suggests that today's models are not best suited to valuing employee stock options. Using different estimates of volatility or of expected service from an employee would result in different measures of fair value for otherwise similar compensation packages.

In their final standards, the FASB and the IASB should articulate clearly for both preparers and users of financial statements the judgments, assumptions, conventions, and potential anomalies that option-pricing models introduce. All stakeholders, including regulators, need to understand these limitations in order to avoid creating an expectation gap from an over-simplified assumption that different users of a model will compute the same fair value for an option in similar circumstances.

We believe the FASB and IASB should undertake an extensive study or participate in such a study to attempt to develop best practices among option pricing models to cope with the many variables that must be addressed in grant-date measurement. Until that study is completed and properly vetted, neither the IASB nor the FASB should mandate the use of any one option-pricing model to determine the fair value of options and similar arrangements.

## MEASURING COMPENSATION IN UNITS OF SERVICE

The IASB developed a "units of service" method to measure and allocate the fair value of the equity award to the employee services received. The company assumes that at grant date the total fair value of the equity instruments granted equals the total fair value of the employee services that the entity expects to receive during the vesting period. The company then calculates value per unit at the grant date, using an expected number of units of service adjusted for expected levels of employee departure and the expected timing of those departures. The company applies the same grant date forfeiture estimate to both the fair value of the award and to the initial estimate of the units of service. This concept is demonstrated in the boxed set of scenarios.



The fair value related to the units of service provided by the employee is recognized in each period as an expense. Effectively this spreads the expected cost over the vesting period. The total cost over the life of the award is ultimately measured at the number of units of service actually received during the vesting period multiplied by the fair value per unit of service determined at the grant date.

Under the IASB's units-of-service method, expense is recognized for service by employees who subsequently forfeit awards, and the accumulated expense for employees that forfeit their awards is not reversed into income. This is because expenses are recognized in earnings as services are provided during the vesting period and are not reversed even if the award is never granted.

The IASB proposal requires the units of service method to be applied to both time-based and performance-based awards. This allocation method is supportable for a time-based award earned by employee service (i.e., time-vesting award). However, when applying it to performance-based awards (e.g., an award based on an earnings-per-share target), there is little correlation between allocating the units based on time and the entity's achievement of the target.

## The Proposed IASB Accounting Model and Statement 123—A Comparison

Assume a company grants options to 100 employees with a combined fair value determined by an option-pricing model of \$1,000,000. The options become exercisable if the employee completes one year of service for the company (i.e., the vesting condition). Historically, 20% of the employees leave each year. Therefore, the company assumes at the grant date that 20 employees will leave evenly during the upcoming year, which translates to an estimated 90 units of service to be received. Ninety units of service are based on 80 employees each performing one full year (or unit) of service and 20 employees each performing a half-year (or half-unit) of service.

Under the IASB proposal, the fair value at grant date is \$800,000, which is the option-pricing-model value of \$1,000,000 reduced by the grant-date estimate of forfeitures.

Scenarios	Total Expense Under IASB Proposal	Total Expense Under Statement 123	Difference in Compensation Expense
Actual employee departures equal the estimate made at grant date (20%)	\$800,000 <sup>a</sup>	\$800,000 <sup>b</sup>	\$0
During the vesting period, no employees leave	\$888,888 <sup>c</sup>	\$1,000,000	(\$111,112)
During the vesting period, all employees leave evenly throughout the year	\$444,444 <sup>d</sup>	\$0	\$444,444

(a)  $((\$1,000,000 \times 80\% \text{ employees who are expected to meet the vesting requirements}) / 90 \text{ units of service estimated at grant date}) \times 90 \text{ units of service performed}$ .  
 (b)  $\$1,000,000 \times 80\% \text{ employees who meet the vesting requirements}$ .  
 (c)  $((\$1,000,000 \times 80\% \text{ employees who are expected to meet the vesting requirements}) / 90 \text{ units of service estimated at grant date}) \times 100 \text{ units of service performed}$ .  
 (d)  $((\$1,000,000 \times 80\% \text{ employees who are expected to meet the vesting requirements}) / 90 \text{ units of service estimated at grant date}) \times 50 \text{ units of service performed}$ .

**Expense Recognition under the IASB Proposal.** As shown above, the total expense under the IASB proposal varies depending on the relationship between the estimate of the units of service made at the grant date and the actual service units performed.

- If the estimates of both the number and timing of employee departures made at the award's grant date are borne out by subsequent events, the original fair-value estimate made at grant date equals the final compensation expense recognized — \$800,000 in the example.
- If the units of service actually provided during the vesting period are higher than those estimated at the grant date (i.e., more employees stay than originally expected), the compensation expense recognized of \$888,888 is greater than the original fair-value estimate.
- If the units of service actually provided are less than those estimated at the grant date, the compensation expense recognized is lower than the original fair-value estimate. The compensation expense of \$444,444 is recognized based on the units of service rendered, even though no awards are ever granted.

**Expense Recognition Comparing the IASB Proposal to Statement 123.** As also shown above, the difference in compensation expense between the two standards can vary.

- If the estimates of both the number and timing of employee departures made at the award's grant date are borne out by subsequent events, the compensation expense under Statement 123 and the IASB proposal are equal.
- If the units of service actually provided are higher than those estimated at the grant date, the compensation expense under Statement 123 of \$1,000,000 will be higher than that under the IASB proposal, because the estimate of forfeitures included in the fair value at grant date is not adjusted under the IASB proposal for subsequent increases in units of service.
- If the units of service actually provided are less than those estimated at the grant date, the compensation expense under Statement 123 of \$0 will be lower than that under the IASB proposal because the IASB proposal recognizes expense for employees' services performed prior to their departure.



The IASB plans to issue its final standard in time for companies to adopt it generally beginning in 2004 (i.e., in annual financial statements for periods beginning on or after January 1, 2004). If the IASB issues on schedule and the FASB sticks to its convergence timeframe, including issuing an exposure draft this year, the same effective date would apply to U.S. companies.

There is much work to be done, whether within this tight standard-setting timeframe or under less pressing time constraints. This subject has received intense discussion in the past, but the current project will likely determine accounting for stock-based compensation for a long time. The FASB is therefore obligated to arrive at the best accounting.

The compressed standard-setting timeframe could make it more difficult for interested parties who want to submit their views and analyses to develop their comment letters. It would nevertheless serve the cause of quality standards if interested parties responded. That and the Board's due-process procedures are supposed to open the way for all arguments to be considered. We encourage interested parties to provide their counsel to the FASB.

Companies should not treat the descriptive and summary statements in this presentation as if they are or capture requirements the FASB or IASB will finally adopt on stock-based-compensation accounting. The FASB and IASB projects described above have not yet resulted in standards, and the related issues are still under consideration. Companies should consult final requirements and their accounting and legal advisors. Additional information on stock-based-compensation accounting is available from KPMG LLP.

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