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Employee stock option accounting : FASB 123(R), SEC SAB no. 107 : other recent authoritative developments; Financial reporting alert

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FINANCIAL REPORTING ALERTS

Employee Stock Option Accounting: **FASB 123(R),** SEC SAB No. 107

Other Recent
Authoritative Developments



123(R)

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA[®]

Louis P. Le Guyader, Ph.D., CPA

Employee Stock Option Accounting: FASB 123(R), SEC SAB No. 107

Other Recent Authoritative Developments

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS



Louis P. Le Guyader, Ph.D., CPA

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Errors communicated to the author in this description of FASB Statement No. 123(R) will be corrected and posted at www.kerlouet.org (see below). For those readers responsible for compliance with these rules, there is no substitute for reading FASB Statement No. 123(R) and Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 107 and they should do so.

Internet Support for This Financial Reporting Alert

The author will support this work from time to time with an Internet depository located at www.kerlouet.org (see the Stock Options tab). This electronic depository will contain any corrections to the work that come to the attention of the author. It will also feature periodic updates on new SEC rules and announcements relevant to FASB Statement No. 123(R) and additional resources as the topics of fair value estimation and employee stock option (ESO) accounting policy progresses. This Internet site will contain downloadable copies or links to documents cited in this work. Purchasers of this Financial Reporting Alert should obtain their user name and password by writing to the author; readers who identify errors requiring corrections, or who have information requests, should also write directly to the author. The author can be reached at lleguyad@aol.com.

About the Author

Louis P. Le Guyader has been active in the capital markets as an accountant and banker for over 30 years. He returned to PricewaterhouseCoopers (PWC) while completing his doctorate in accounting at Columbia University, where he was the Coopers and Lybrand Scholar. At PWC he specialized in various aspects of accounting and disclosure for financial instruments, hedging, risk management, and fair value methodology as a member of the National Office and as a founder of the Financial Risk Management Group. He has published several texts on accounting policies for derivatives, hedging, and the use of special-purpose entities in structured finance. As a banker he has specialized in international and cross-border financings, including the use of derivative and structured finance. At Columbia, his dissertation in financial accounting addressed the topic of financial risk and risk modification. He has been an independent accounting consultant since 2000 and has held faculty positions at Columbia University's Graduate School of Business and Princeton University. He is a New York State CPA.

EMPLOYEE STOCK OPTION ACCOUNTING: FASB STATEMENT NO. 123(R), SEC SAB NO. 107, AND OTHER RECENT AUTHORITATIVE DEVELOPMENTS

Executive Overview of FASB Statement No. 123(R)¹

The accounting for employee stock options (ESOs) and other equity and equity-linked instruments that are exchanged by a public entity in return for services is governed by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*. The measurement of the cost of the service must now be based on the grant-date fair value of the award (generally, the ESO). The cost must be recognized over the period over which the employee renders the service, most often understood to be the vesting period of the ESO. If the award is a liability instrument, its recognized cost based on fair value must be remeasured at each reporting date through the instrument's settlement date; the fair value changes will be recognized as a cost of compensation. A nonpublic entity that finds that it is not possible to reasonably estimate the fair value of the award because the expected volatility to the fair value cannot be estimated practicably can base the fair value of the award using an appropriate industry sector volatility index. A nonpublic entity may elect to measure its award of liability instruments at their intrinsic value. The grant-date fair value of the equity-linked instruments will be measured using option pricing models with adjustments to parameters and other inputs to reflect the unique characteristics of the instruments. Modifications of equity awards require the recognition of additional fair value. Excess tax benefits will be recognized as an addition to paid-in capital and cash retained as a result will be presented as a financ-

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1. The full summary of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*, can be found on pages ii and iii of the full text of the accounting standard.

ing cash flow in the statement of cash flows. The write-off of unrealized tax benefits, absent an offsetting amount, will be recognized as income tax expense. The notes to the financial statements will disclose information on the nature of share-based transactions and their effects on the financial statements as a whole.

Introduction

U.S. generally accepted accounting principles (GAAP) will require companies to expense the cost of ESOs, starting with their fiscal years that begin after June 15, 2005. The effective date for FASB Statement No. 123(R) was delayed by the Securities and Exchange Commission (SEC), in a press release dated April 14, 2005. That announcement was made after the release of SEC Staff Accounting Bulletin (SAB) No. 107, *Share-Based Payment*, on March 29, 2005, and FASB Statement No. 123(R) on December 14, 2005. The original effective date was interim periods beginning after June 15, 2005 (that is, the quarter beginning July 1, 2005, for calendar year companies). Voluntary expensing of the cost of ESOs has been permitted since the issuance of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, in October 1995. The central requirements for this accounting principle are described in FASB Statement No. 123(R) and additional implementation guidance has been provided through the issuance of SAB No. 107. This Alert explains the accounting for ESOs by describing FASB Statement No. 123(R), summarizing SAB No. 107, and supplementing this knowledge with additional information developed by the capital markets and the accounting field.

The FASB issued FASB Statement No. 123(R) in December 2004, after nearly two years of redeliberation of FASB Statement No. 123, which was originally issued in 1995.² The central provisions of FASB Statement No. 123(R) require “[a] public entity to measure [and recognize] the cost of [ESOs] based on [their]

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2. The controversy surrounding the question of accounting policy for employee stock options (ESOs) has been significant to the FASB’s standard-setting agenda for at least eight years.

grant-date fair value”³ where the “grant-date fair value of [the ESOs] . . . will be estimated using option-pricing models adjusted for the unique characteristics of those instruments. . . .”⁴ The statement also contains related guidance on certain tax issues associated with ESOs (see Appendix B of FASB Statement No. 123(R)) and disclosures that must be provided in the notes to the financial statements.

SAB No. 107 contains implementation guidance emphasizing that the “grant-date fair value” per FASB Statement No. 123(R) should be the equivalent of an “exchange price” for ESOs, a provision that must be evaluated by the SEC issuer in light of the fact that ESOs are neither traded nor transferred in any market.

The accounting rules for ESOs in FASB Statement No. 123(R) and SAB No. 107 have three main parts: fair value measurement of the financial instruments, recognition on the balance sheet, and recognition of the compensation cost of ESOs in the income statement. Users will need to understand their ESO contracts completely to apply the relevant provisions of FASB Statement No. 123(R); “Section I: What Are Employee Stock Options?” in this Alert describes the characteristics of ESOs. A description of the economic controversies that surround ESOs, including the accounting issues addressed by FASB Statement No. 123(R), are discussed in this Alert in “Section II: What Is the Controversy Behind Stock Option Expensing?” FASB Statement No. 123(R) is summarized in the third section, and the likely effects of FASB Statement No. 123(R) are addressed in the fourth section. A summary of SAB No. 107 is presented in Section V. The fair value measurement of ESOs is further described in Section VI. Methods of minimizing ESO expense are summarized in Section VII. Section VIII provides a summary of the most recent authoritative developments from the SEC and the FASB.

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3. FASB Statement No. 123(R), page ii.

4. FASB Statement No. 123(R), page iii.

Section I: What Are Employee Stock Options?

The scope of FASB Statement No. 123(R) and the accompanying guidance of SAB No. 107 provide accounting rules for “share-based payments,” which are compensation arrangements in which “an entity exchanges its equity instruments for goods or services.” Generally, FASB Statement No. 123(R) will apply when (1) the employing entity issues an equity-linked derivative contract to its employee in exchange for the employee’s time and effort⁵ and (2) the equity derivative contract is settled by the delivery of equity shares, instead of cash or access to some cash-producing market mechanism. The equity-based contract is labeled an ESO for the purposes of this Alert. For an ESO, the employer’s contract counterpart must be an employee, and the contract must generally take the form of an over-the-counter derivative contract, which is a type of executory contract.

The status of the contract counterpart is a critical characteristic of ESOs. ESOs almost always combine some element of compensation in lieu of salary with an equity-sharing between business partners. Employees could certainly describe ESOs as rewards for their “sweat equity.” There is a wide range of compensation agreements across entities. Sometimes the ESO is the only compensation paid, but more frequently it is one of several components of a compensation package that includes salary, incentive pay, and benefits. Under the provisions of FASB Statement No. 123(R), ESOs must be treated as a substitute for cash salary. In SAB No. 107, the SEC buttresses this policy decision by pointing out that in the income statement, the ESO compensation cost should be displayed on the same line item as any other salary expense.

The form of the ESO contract fits easily into the general definition of a derivative as displayed in paragraph 6 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as described in the following table.

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5. An employee may receive an equity award in the form of an equity derivative (generally, an ESO) or shares with some restrictions (generally, restricted stock). It is easiest to consider option-pricing models as suiting the valuation of ESOs and similar derivative instruments.

Defining an Employee Stock Option as a Derivative Instrument Using FASB Statement No. 133 Definitions¹

*FASB Statement No. 133,
Paragraph 6: Characteristics
of a Derivative*

*Standardized Employee Stock
Options Terms*

At least one “underlying,” and at least one “notional amount” or payment provision or both

The employee stock option (ESO) underlying is the issuer’s equity stock. One way to express the notional amount is the number of shares times the market price at the grant date.

Requires “no initial investment” or an initial investment below the exchange price for similar instruments²

Options are normally exchanged for an up-front premium, which satisfies this initial investment characterization.³

Terms require net settlement and (in the case where it cannot be settled outside the contract) it provides for delivery of an asset with a value that is equivalent to net settlement.

When an ESO is exercised, the employee-holder pays the strike value in cash to the issuing employer-entity and receives equity shares. The equity shares can be sold into the market for cash at the current market price without restriction.

1. Copyright 2005, Louis P. Le Guyader. Used by permission.

2. Please refer to the article “Feltham-Ohlson Parameterization of ESOs,” by Louis P. Le Guyader, 2005, which is available at www.kerlouet.com.

3. In ESOs, the premium exchanged is not cash, but the employee’s labor. The fair value of the ESO estimated at the grant date is both the best estimate of the exchange price for the ESO and the initial investment that satisfies this definition.

Immediately after a series of derivative losses in the period 1993–1994, the SEC Chief Accountant staff explained that there could be a high risk of unexpected potential loss for derivative financial instruments that were not adequately presented in the entity’s SEC reports. Within the category of derivatives, options and all short positions in general were considered the riskiest form of contracts for the purpose of achieving transparent reporting. The FASB’s response to this concern in the case of most financial derivatives was the issuance of FASB Statement No. 133, which imposes the central requirement that derivatives should be recognized on the balance sheet and measured at the carrying amount, which should equal the fair value of that instrument. FASB Statement No. 123(R) was the FASB’s specialized response to the case of ESOs. (The FASB chose not to include ESOs under

the scope of FASB Statement No. 133 because of the special considerations that apply to ESOs as compared with other financial derivative instruments. See paragraph 11(b) of FASB Statement No. 133.)

The ESO contract is normally more complex than exchange-traded options or shorter maturity over-the-counter options. The contract terms that differentiate ESOs from other options include:⁶

- A long time to maturity, usually more than three years and normally five years or longer.
- An initial period before the contract is “vested” and during which (1) the employee is sometimes considered to be delivering the services for which the contract is exchanged and (2) exercise is not permitted.
- An exercise period⁷ during which the holder can exercise at any time.

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6. This list is not meant to be exhaustive. The contract form of ESOs remains very diverse and relatively uncatalogued. A separate issue is the frequency with which ESOs are awarded in a form that they should be considered equity or liability items for purposes of financial statement presentations. The author and the AICPA reviewers of this text know of no study that has yet been completed on this question. ESO arrangements designed to be settled with cash or a cash-producing market mechanism should be reviewed for potential classification as a liability; ESOs designed to be settled through the transfer of shares should be reviewed for potential classification as equity. The accountant’s and auditor’s examination of whether a financial instrument is designed to or actually does result in cash settlement has proven a systematically difficult topic, including similar questions of classification under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Users of FASB Statement No. 123(R) should conduct complete reviews of the ESO contract, their settlement provisions, and the issuer’s experience with settlement practice before accepting a suggested balance sheet classification as liability or equity.

7. The exercise period within an ESO contract term can be clearly documented within the ESO contract but is affected by other contracts or policies of the issuer to which the ESO holder-employee is subject. For example, senior executives may hold exercisable ESOs but may be prohibited from exercising during “blackout” periods around, for example, earnings releases, other key developments, or the normal operations of the Securities and Exchange Commission (SEC) Regulation FD.

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- A fixed expiration date.⁸
 - Forfeiture in the case of termination of employment.
 - No transferability.
 - No secondary market trading possibility.
 - Relative ease in altering the contract terms after the initial grant date.

The last contract term deserves some elaboration. Each ESO is a contract that can stand “on its own” with respect to the context in which it is issued and the prospect that it can be altered. Alteration normally occurs in a voluntary renegotiation between the employer and the employee. Two instances have occurred frequently as examples of the ability to alter the terms of the ESO after the initial grant date:

1. When the market for the entity’s equity drops without chances of near-term recovery, the expiration date is extended, or the strike price is lowered as a means of preserving the use of the contract as an incentive tool.
2. Due to the transition provisions included in FASB Statement No. 123(R), the entity asks to accelerate the vesting date, thereby carving out the altered ESO from the provisions of FASB Statement No. 123(R).⁹

In a typical ESO option contract, the entity issues the option to the employee and assumes the prospective risk that it will have to deliver its equity shares to the holder at the strike price when the

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8. ESOs are contracts and, as such, when documented normally carry a fixed expiration date. This is akin to the “maturity date” of a debt instrument issued as a liability or purchased as an “investment in a marketable security.” The ESO contract can end before the contractual maturity date if it is “accelerated.” Acceleration is sometimes triggered by an event that the accountant and auditor can verify, such as the termination of the holder’s employment. Fixed expiration dates that are subject to acceleration and the restrictions identified in FASB Statement No. 123(R) give rise to the need to carefully estimate the expected term of the ESO or in some cases de-recognize it from the financial statements.

9. For a recent research report on this phenomenon see the Bear-Stearns Equity Research, Accounting and Tax Policy, “Spring-Cleaning: Companies Accelerate Vesting of Stock Options,” April 7, 2005.

market price is above that level. The entity is an “option writer” and the ESO represents a “written” or “short” option position. A written option means that the entity is placed in the position of prospectively delivering shares to the employee. The standard ESO contract never provides for the delivery of shares from the employee to the entity.¹⁰ The entity must obtain shares for delivery in the market or, if permitted, use shares already in its possession.¹¹

The “option” form of the contract represents a one-sided bargain for the employee. The employee is permitted but not required to exercise the ESOs; if the market price equals or is less than the strike price, the ESO is presumably not exercised. However, if the employee decides to exercise the ESO when the market price is greater than the strike price, the entity is required to honor the exercise of the option and deliver the shares; therefore, the entity can only suffer an economic loss, and never a gain, as a result of the exercise of the ESO contracts.¹² That loss equals the option’s intrinsic value, which the employee perceives as the bargain element of the ESO. In financial economics, the intrinsic value¹³ of an option is always:

Number of shares X (Market price – Strike price) subject to exercise

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10. If the employee would be able to deliver shares to the entity, the contract would take the form of a written put option from the entity’s point of view.
 11. In some state jurisdictions and in many ESO issuers, there are some combinations of legal and governance limitations placed on the way the entity obtains shares to service its ESO obligations.
 12. This ignores the potential economic benefit and creation of wealth the entity receives from the employee’s labor.
 13. FASB Statement No. 123(R)’s definition of *intrinsic value* is consistent with the financial economics definition of the term. The glossary of FASB Statement No. 123(R) states in part that intrinsic value is “the amount by which the fair value of the underlying stock exceeds the exercise price of the option.” In the case of a public entity, the market price of its stock is generally understood to be the best estimate for the fair value of its stock. For a nonpublic entity, volatility of the entity’s stock cannot be determined from observable changes in its stock price, as the stock is not traded. In these cases FASB Statement No. 123(R) defines a *calculated value* as a measure based on a substituted historical volatility. See the FASB Statement No. 123(R) Glossary, which is Appendix E to the accounting standard.

Employees are normally very favorable to an ESO grant due to the “limited liability” conditions that are standard to every option: The employee can never lose money; the minimum outcome is never less than a “zero” payout; the exercise of the option normally is only accompanied by an economic gain; and it is normally easy to “cash out” on the date of exercise by selling the shares in the market.¹⁴

From the entity’s point of view, the ESO represents a prospective loss at least equal to the intrinsic value that is reserved for the employee. In this respect, the ESO is a cost that represents a discount to the market value of the shares issued to the ESO holder.

For example, if an ESO is issued with a strike price of \$10 per share for 100 shares and exercise is permitted, the employee may choose to exercise the shares when the shares are trading in the market for \$15 (assuming exercise is permitted). If exercise occurs, the entity receives \$10 per share and issues all the shares. Before FASB Statement No. 123(R), the entity would only record the option exercise on the exercise date. On the exercise date the entity would record:

Debit cash (at \$10 per share)	\$1,000
Credit common stock (net of discount of \$5 per share)	\$1,000

The reader of the financial statements could ascertain the realized dilution effect on the exercise date by observing the number of shares issued below market price as reported in the equity section of the balance sheet. If the company had to enter the market to obtain the 100 shares to cover the written ESOs, the company would have paid \$15 per share for shares that it would distribute under the ESOs for only \$10. The \$5 per share loss would be a true cash outflow, but by convention, before FASB Statement No. 123(R), that loss would not have been reported as an earnings loss. However, it is rare that an entity places itself in this position. Most entities cover their ESO exposure by either reissuing shares held in treasury (to the extent this is both

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14. The employee’s retail broker sometimes can advise on whether exercise of the options is appropriate, or whether retaining the shares is preferable to selling them for cash. The broker could be called on to execute the trades of the equity securities.

legal and permitted) or issuing new shares (to the extent this has been properly authorized).¹⁵

Thus, the employee is paid whatever intrinsic value the market will permit; the amount and the timing presumably depend on external market factors outside of the entity's control. The intrinsic value cash flows are derived not from the entity but between the market and the employee. On the other hand, the equity financing cash flows (cash flows upon exercise) do flow between the employee and the entity at the strike price within the ESO contract.

The complexity of ESO contracts is self-evident. The fact that ESOs are derivatives in the entity's own equity and that they create a legal and economic obligation to deliver shares at an unfavorable price has created some unique accounting policy issues and matters of debate. Since the issuance of FASB Statement No. 123(R) in December 2004 it has also become apparent that management of the issuer's ESO profile adds to this complexity. Employees may perceive some benefit from renegotiation of ESO contract terms after the initial grant date, especially if these contract alterations increase the chance of a profitable ESO exercise. In some cases contractual changes may not represent appropriate managerial conduct (for example, back dating ESO awards to reflect favorable current market conditions or to address the financial needs of an employee). The transition provisions for FASB Statement No. 123(R) also permitted some relief from the provisions of the accounting standard for ESOs whose terms were modified before the standard took effect. (The issuer's incentive to modify the ESOs in this case was to achieve a grandfathering of the contract and so exempt it from the recognition provisions of FASB Statement No. 123(R).) The financial statement preparer and the issuer's auditor should be particularly attentive to all contract alteration activity.

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15. The use of the law and the emergence of best practices in corporate governance could be used to temper some of the excesses in the use of ESOs.

Section II: What Is the Controversy Behind Stock Option Expensing?

ESO compensation that appeared to be excessive triggered the perceived need for FASB Statement No. 123(R) and “stock option expensing.” Two other factors contributed to this need: earnings manipulation and the element of surprise investors felt when ESO pay was reported. Detractors of FASB Statement No. 123(R) suggest that the standard should not take effect because they believe it cannot be implemented efficiently and because it damages ESO use as one of the most powerful incentive formulas available to the labor market. The tension between these opposing camps has led to the controversy that continues to this day.

ESO Compensation and Earnings Manipulation

Potential ESO pay rises with an entity’s stock price. If that stock price has been conditioned to respond to earnings, and if managers are unscrupulous and manipulate earnings upward, the stock price can be improperly inflated. Two overriding themes in recent accounting scandals have been the improper accounting treatment of off-balance-sheet transactions, and earnings manipulation.¹⁶ The complaint that ESO compensation is excessive seems appropriate in cases where the executive responsible for earnings manipulation also benefits from an artificially high stock price.¹⁷

ESO Compensation as Undisclosed Compensation

That ESO compensation exists at all sometimes comes as a surprise to many investors. Some investors see ESO compensation as “secret pay,” especially when they learn of it not from the audited

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16. For a summary of the concern that the Securities and Exchange Commission (SEC) has shown about earnings manipulation, see the 1998 speech, “Numbers Games,” given by former SEC Chairman Arthur Levitt at New York University’s Law School. The speech can be found in the SEC Chairman archives on www.sec.gov.

17. See, for example, the details of compensation arrangements and earnings manipulation tactics within evidentiary deposits used to gain guilty pleas from or convict former WorldCom executives.

financial statements but from press releases that are sometimes tied to SEC enforcement actions. In the last 10-year period before the introduction of FASB Statement No. 123(R), the accounting for ESOs was governed by FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123*. These standards encouraged but did not require the recognition of stock compensation expense related to ESOs; they only required audited disclosures about ESOs in the notes to the financial statements. The persistent anecdotal reports of investors' surprise regarding the uses of ESO compensation suggest that these disclosures were not informative, or worse, never read.

At the same time, there is an intuitive rejection of the notion that a paper contract can yield high compensation and a common misunderstanding about where the cash paid to the employee comes from. The cash comes from the market when the employee sells the shares he or she has purchased at a bargain. It does not come from the SEC issuer—it is not a cash outflow of the entity, but it is the entity's opportunity cost.¹⁸ The leverage that is inherent to every derivative sometimes works against the ability to communicate the prospective cash flow attributes of the ESO transparently.

The FASB's Solution—Fair Value Accounting

Financial instruments that are derivatives, options, and written or short positions, and that are significantly leveraged, have concerned the SEC for some time, because of their accounting complexity. ESOs possess all four of the aforementioned characteristics. When faced with a similar concern about unwanted surprises from other financial derivatives, the FASB

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18. In his economics textbook, N. Gregory Mankiw explains the difference between economic profit and accounting profit. Not all opportunity costs, especially implicit opportunity costs, are captured by the accounting model. FASB Statement No. 123(R) creates a method for recording the opportunity costs associated with ESOs in a manner that hastens the convergence of economic and accounting profit.

sought to make the use of financial instruments understandable,¹⁹ by issuing FASB Statement No. 133 in 1998.

The FASB's philosophy to improve accounting for all financial instruments has been to recognize them on the balance sheet, using the fair value of the instrument as the carrying amount. Fair value accounting had been introduced by certain FASB accounting standards, including FASB Statement No. 133, in an attempt to change the traditional historical-cost-based accounting model. Appendix A of this Alert provides a summary of other key standards that have been issued as part of the FASB's project on financial instruments.

The current accounting model requires the measurement of fair value of certain items, while other values are required to be determined by their historic costs. Most financial statements prepared under 1994–2005 era GAAP therefore represent a “mixed attributes” accounting model, combining some historic cost measures with fair value measures.²⁰ A complete fair value accounting model requires that:

- An item that is recognized in the financial statements must be carried on the balance sheet using a carrying value equal to its fair value.
- This carrying value should be updated to the item's current fair value at each reporting date, with the changes in fair value from the previous reporting date recorded in income (earnings or other comprehensive income).

The FASB considers fair value to be the best measure for reporting financial instruments. The FASB has documented its preference to display unrealized gains and losses related to fair value fluctuations from financial instruments in income generally because, among other things, the opportunity costs of these values

19. This paraphrases one of 10 points, or policy imperatives, designed to clean up the capital markets discussed by President George W. Bush immediately after the fall of Enron.

20. For an explanation of the mixed attributes accounting model, see the FASB Financial Accounting Series Special Report, “Major Issues Related to Hedge Accounting,” Jane B. Adams and Corliss J. Montesi, October 1995.

are considered to be relevant—they should be provided to the investor. FASB Statement No. 123(R) is the newest effort to apply that concept to yet another class of financial instruments.²¹ FASB Statement No. 123(R) uses elements of both fair value and historic cost approaches to account for ESOs, starting from the estimation of the grant-date fair value of the ESOs. (See “Section VI: What Is the Value of a Stock Option?” in this Alert for an explanation of the logic underlying this approach.)

FASB Statement No. 123(R) therefore requires that ESOs be recognized on the balance sheet at fair value, and that the cost represented by the grant date fair value be recorded or charged to earnings as an expense. The resulting increase in expenses would potentially reduce the combined ill effects of earnings manipulation and “secret pay” sentiment felt by investors as a result of the use of ESOs. The threefold accounting improvements (balance sheet recognition, fair value measurement, and expensing through earnings) are expected to help mitigate inappropriate forms of ESO compensation and the lack of accounting transparency that accompanied such ESO transactions.

Arguments Against the Implementation of FASB Statement No. 123(R), and the FASB’s Response

FASB Statement No. 123(R) detractors have assembled a powerful arsenal of arguments against the fair value accounting approach. Due to the forcefulness of their arguments, they have successfully delayed the effective date of FASB Statement No. 123(R) from 2005 to an effective date starting with fiscal 2006.

Public policy makers who are involved in the “capital markets cleanup” are concerned that FASB Statement No. 123(R) will not add to an understanding of how these financial instruments are used. They point out that until earnings are made more transparent, the inclusion of ESO expenses on the income statement provides new manipulation opportunities, thereby causing the income statement to be even less transparent. Financial engineers

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21. FASB and SEC rules generally split all financial instruments into two categories: derivatives and other financial instruments, which include debt and equity.

and financial economists also suggest that FASB Statement No. 123(R) should be further postponed or rescinded because it cannot be implemented. They claim there is no reliable way to estimate an ESO fair value: the ESO contract is too complex to fit into models that were not intended for valuing ESOs, and the value derived in a mark-to-model valuation methodology will never be akin to an exchange price. However, accounting regulators have recently reminded the market, that, in effect, a potentially flawed statistic can still be sufficient for purposes of achieving the policy objectives of FASB Statement No. 123(R). The SEC has also stated that it would accept future improvements in any SEC issuer's valuation methodology if the issuer made a retrospective criticism of values lodged in previous financial statements; this level of reasonableness is almost a safe harbor that enables FASB Statement No. 123(R) to move forward with an acceptable level of measurement risk.

Computer scientists and systems experts point out that FASB Statement No. 123(R) requires substantial computer support, which may not be available. If systems have not been configured to support FASB Statement No. 123(R) and enable fair value measurement, or the available systems cannot be integrated into a general ledger package, according to systems experts, either FASB Statement No. 123(R) may not be feasible or more time should be given before it becomes effective. Similar arguments won postponements of the effective dates of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and FASB Statement No. 133. The SEC considered these comments when it delayed the effective date for FASB Statement No. 123(R) to fiscal 2006.

The labor market reaction to the FASB Statement No. 123(R) ESO controversy has been mixed. In larger manufacturing organizations, labor unions have supported ESO expensing. They believe that union members have effectively been impoverished to the extent that the employer's resources are allocated to executives

through ESOs.²² On the other hand, high tech industry workers in particular have taken the position that the decreased use of ESOs, which has been the secondary effect of the accounting deliberations, has hurt the high tech industry as a whole. In the high tech industry, ESOs are seen as the most efficient incentive for workers to perform at a time when the employing entity has an insufficient cash flow to pay salaries at the entity level. A repeated defense of ESO compensation is that the cash payment received by the employee is paid by the market, not by the entity. Such compensation strategy uses a sweat equity philosophy: the market value of the entity increases only if workers perform; otherwise the entity becomes bankrupt. ESOs are merely a means to give workers their share of the market wealth that has been created by their own efforts.

That argument then provokes an expected reaction from outside existing shareholders, who decry the dilution risk that accompanies the exercise of ESOs. However, certain segments of investors remain convinced that ESOs will not lead to dilution if there is a compensating increase in the market value of the entity. The dominant reason the entity becomes more valuable is that wealth is created by the properly induced worker. These FASB Statement No. 123(R) detractors, including the high tech industry, see ESOs as equity transactions, not as earnings events. Recall the siren call of the Enron whistleblower who reminded Congress that a basic accounting concept is that earnings are not derived from changes in equity. However, FASB Statement No. 123(R)'s response to this argument is that basic accounting exclusions may not apply because of the way the ESO equity derivative contract is structured or because of the way the ESO derivative is settled in practice.

Accounting theoreticians at major universities, after accepting the inevitability of expensing, have joined the arguments by asking

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22. In the case of accounting irregularities such as those uncovered at WorldCom and Tyco, the claim that executives have impoverished workers and investors alike seems valid. One would wonder how union members would argue their cause if they were granted ESOs and those grants were terminated by the company as a reaction to FASB Statement No. 123(R).

for improvements to FASB Statement No. 123(R). This has been incorrectly perceived by the “antiexpensing crowd” as further evidence that FASB Statement No. 123(R) should be terminated. To the contrary, the FASB has a successful record of updating standards after their issue date to reflect new information from the market that justifies renewed deliberations. For example, FASB Statement No. 133 has been amended by three subsequent accounting standards (FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133—an amendment of FASB Statement No. 133*; FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities—an amendment of FASB Statement No. 133*; and FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*), and there are ongoing deliberations in various FASB venues (the Emerging Issues Task Force (EITF), the Derivative Implementation Group (DIG), and the full FASB itself).

Proposals to amend FASB Statement No. 123(R) have mostly focused on aligning its accounting policies to a full fair value accounting model, including:

- Marking-to-market the ESOs on every reporting date, as with any other derivative.
- Recognizing and developing a link to one form of the underlying item, on which ESOs may be matched to treasury shares.
- Eliminating some inefficiencies in the way ESO fair values are recorded (see Section V).
- Removing, or reversing, the expense from the financial statements on the ESO expiration date if they expire and are worthless.
- Finding ways to account for the equity financing attribute of the ESO transaction more transparently.
- Opening the possibility that other comprehensive income (see FASB Statement No. 130) should be used to charge

ESO expenses and subsequent fair value changes, rather than earnings.

- Urging that the balance sheet location for the “ESO derivative account” be either in equity or liabilities, but not both (see FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*).

These proposals signify the heated nature of the ESO controversy over the past 10 years. By far, the stock option expensing debate outside of the FASB has focused on “no expensing through earnings” and informing the market that “no valid valuation methodology exists.” For many years, these two critical policy controversies dwarfed other stock-compensation-related issues before the FASB; with the release of FASB Statement No. 123(R), related accounting topics are now being debated in depth.²³

Section III: Summary of FASB Statement No. 123(R)

FASB Statement No. 123(R) requires expensing the cost of ESOs and also provides accounting policies for other types of share-based payments.

Scope²⁴

FASB Statement No. 123(R) applies to any transaction in which the entity makes payment through a share-based contract or other arrangement:

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23. ESO accounting is enabled by the migration to fair value accounting for all financial instruments. Some of the more recent suggestions for improvements of FASB Statement No. 123(R) did not appear within the FASB discussions since the fair value principles had only recently been applied in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and FASB Statement No. 133. The FASB’s approach is to provide for extensive deliberations and due process when considering all accounting policy suggestions.

24. FASB Statement No. 123(R), paragraph 4.

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1. A share-based payment is one where the entity issues or offers to issue share instruments or incurs a certain type of liability.
 - a. The share instruments may be the entity's shares, options on its shares, or certain other equity instruments.
 - b. The liability must be based on, or indexed to, the share price or the price of some other equity instrument, or the liability requires or may require settlement by issuing the entity's shares or other equity instrument.
 2. The payment (that is, share issuances) may be made in return for goods or services.
 3. The payee may be an employee or other supplier.

ESOs are share-based payments to employees exchanged for services and settled with the issue of shares.

The Central Accounting Policies

The central accounting policies of this statement pertain to recognition and measurement.

1. *Recognition.* The entity must recognize the cost of share-based payments (including ESOs) in the financial statements when the goods or services are received. The entity may need to recognize an asset when the share-based payment contract is created in advance of the receipt of the good or services.²⁵ The compensation represented by the share-based contract may represent an expense (compensation expense) in current earnings or may be capitalized as part of the cost to acquire an asset (compensation cost).²⁶
2. *Measurement.* The value of the payment shall be measured at fair value as follows:
 - a. *If the payment is to a nonemployee.* The value is that of the goods or services received if that value is more

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25. FASB Statement No. 123(R), paragraph 5 and footnote 4.

26. FASB Statement No. 123(R), paragraph 5 and footnote 5.

reliably measurable than the fair value of the equity instruments in question.

- b. *In all other cases.* The value is the fair value of the equity instruments issued, *except in certain cases when the payment is to an employee*, the calculated value or intrinsic value may be used in place of the fair value.²⁷

FASB Statement No. 123(R) addresses transactions with employees and nonemployees as well as various forms of share-based payment contracts. For nonemployee transactions or transactions in which the payee is not clearly an employee, the reader should consult FASB Statement No. 123(R) or other governing GAAP.²⁸ The remainder of this summary is focused on employee share-based payments in the form of an equity-based option contract (an ESO transaction).

In addition, the full text of FASB Statement No. 123(R) must be consulted for the treatment of certain transactions with related parties and certain other exceptions. Some employee purchase plans are not governed by FASB Statement No. 123(R) because they are not ESOs (see paragraphs 12 and 13 and Appendix A of FASB Statement No. 123(R)); these plans are “noncompensatory.” However, the introduction of option features to a non-compensatory plan may cause that plan to be considered an ESO and so require the application of FASB Statement No. 123(R). Examples of such features include the right to purchase shares at a discount to the market price (akin to an option strike price), or the right to withdraw from the plan without financial penalty (akin to the right but not the obligation to exercise an option). If the services are paid for by incurring a liability to the employee,

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27. For the definitions of fair value, calculated value and intrinsic value as used in FASB Statement No. 123(R), see paragraph 7 and the Glossary of FASB Statement No. 123(R). See Section V for a discussion of fair values for use in FASB Statement No. 123(R). The reader is urged to consult expected FASB standard *Fair Value Measurement*, when that guidance is released, as it may apply to FASB Statement No. 123(R).

28. The term *employee* is defined in FASB Statement No. 123(R)'s Appendix E, the Glossary.

the fair value of that liability must be remeasured²⁹ at the end of each reporting period through settlement. (For other remeasurement provisions, see the following section.)

Specific Accounting Rules for ESOs

Paragraph 10 of FASB Statement No. 123(R) states: “[The] cost of services received from employees in exchange for [employee stock options] . . . shall be measured based on the *grant-date fair value* of the . . . [ESOs issued].”

The Fair Value Accounting Principles Within FASB Statement No. 123(R)

FASB Statement No. 123(R) recognizes that exchange prices for ESOs or similar instruments are not available to use as the fair value. In such a case, a valuation methodology must be used to estimate the fair value. The fair value of an ESO is expected to have a value different from its intrinsic value, that is, it has time value. The underlying equity share itself does not have time value.³⁰

The Fair-Value-Based Method. Under the fair-value-based method, the grant-date fair value is “[estimated] . . . based on the share price and other pertinent factors . . . at the grant date.” The fair value is “not re-measured in subsequent periods”³¹ unless the compensation award qualifies for treatment as a liability. “Liabilities . . . are . . . remeasured . . . [subsequent to the grant-date]...[on] each reporting date until the liability is settled.”³²

The fair value estimate must reflect the terms of the ESO contract that are considered relevant to the value of that contract. The effects of nontransferability and nonhedgability, as well as

29. The FASB Statement No. 123(R) notion of “remeasurement” is the same as the financial economics notion of “marking a financial instrument to market,” also expressed colloquially sometimes as truing-up the value of an instrument.

30. FASB Statement No. 123(R), paragraph 22 and footnote 12. See Section V of this Alert for a summary of Staff Accounting Bulletin (SAB) No. 107, *Share-Based Payment*, and Section VI of this Alert regarding the fair value of an option.

31. FASB Statement No. 123(R), paragraph A2.

32. FASB Statement No. 123(R), paragraph A6

any postvesting restrictions on selling shares, are thought to be factors that could be represented in the entity's estimate of the "expected term" of the ESO.³³ However, certain ESO terms, including some forfeiture provisions, would not affect the fair value.³⁴ Other contingent events such as a "clawback" are excluded from the fair value calculation until they actually occur.³⁵

The Calculated Value Method. The calculated value method estimates the ESOs' fair value by substituting "the historical volatility of an appropriate industry sector index for the expected volatility . . . in an option-pricing model."³⁶ This method is used by a nonpublic entity when it is impracticable to estimate the expected volatility of its equity security price. In other words, attempts to arrive at estimates of expected volatility, including comparison with another public entity's historical, expected, or implied volatility, have not yielded a suitable estimate. Only in the case of nonpublic entities may a "calculated value" be substituted for the fair value.³⁷

The Intrinsic Value Method. In certain limited cases it is not "possible to reasonably estimate the fair value of an [ESO] because of the complexity of its terms."³⁸ In this case the accounting for the instrument is "based on its intrinsic value, re-measured each reporting date through the date of exercise or settlement."³⁹

Rules for Estimating the Fair Value of ESOs and Valuation Techniques

Paragraph A7 of FASB Statement No. 123(R) relies on the Glossary from FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, for a definition of *fair value*:

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33. FASB Statement No. 123(R), paragraph A3.

34. FASB Statement No. 123(R), paragraph A4.

35. FASB Statement No. 123(R), paragraph A6.

36. FASB Statement No. 123(R), Appendix E.

37. See FASB Statement No. 123(R), paragraph 23, and Section VI of this Alert.

38. FASB Statement No. 123(R), paragraph 24.

39. FASB Statement No. 123(R), paragraph 25.

“[Fair value is the] . . . amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.⁴⁰

FASB Statement No. 123(R) uses the concept of *value in a current exchange*⁴¹ and applies it to ESOs that are classified as either liabilities or equity instruments. The FASB Statement No. 123(R) rules summarized below generally apply to the estimation of fair value for ESO-type contracts, focusing on the “fair-value-based method” described above.

The valuation technique applied should satisfy certain conditions. The resulting fair value, while representing an “exchange price,” must also have certain substantive characteristics. FASB Statement No. 123(R) lists “the minimum set of substantive characteristics”⁴² that should be considered in valuing any option-like instrument, assuming that “the market price is not available”:

- a. The exercise price of the option.
- b. The expected term of the option. . . .
- c. The current price of the underlying share.
- d. The expected volatility of the price or the underlying share for the expected term of the option.

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40. Readers of this Alert and FASB Statement No. 123(R) implementers in general are encouraged to stay abreast of regulatory evolution of the term *fair value*. After the issuance of FASB Statement No. 123(R) in December 2004, the SEC issued a number of documents summarizing their view of valuation methodologies and addressed some specific attempts at market innovation for purposes of FASB Statement No. 123(R) implementation. More broadly, at the date this Alert was written, the FASB was in the final stages of completing and issuing its new accounting standard on fair value, *Fair Value Measurements*. That standard, in particular, should be considered in one’s ongoing implementation of FASB Statement No. 123(R), pursuant to the spirit expressed by the SEC staff in SAB No. 107 that improvements in valuation methodologies over the course of time would be expected.

41. FASB Statement No. 123(R), paragraph A7.

42. FASB Statement No. 123(R), paragraph A11.

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- e. The expected dividends on the underlying share . . . ([subject to certain exceptions]).
 - f. The risk-free interest rate(s) for the expected term of the option.”⁴³

Acceptable valuation techniques for ESOs “estimate the fair value . . . at a single point in time (for example, at the grant date) . . . [which] is not a forecast of what the estimated fair value of those instruments may be in the future.”⁴⁴ Potentially appropriate valuation methodologies include the use of “an option-pricing model.” “A lattice model (for example, a binomial model) and a closed-form model (for example, the Black-Scholes-Merton formula)” are examples of option-pricing models “based on established principles of financial economic theory” that “meet the requirements of FASB Statement No. 123(R)” and can be modified to incorporate the critical characteristics of ESOs.⁴⁵ Having identified these models, the FASB has not stated a “preference for a particular valuation technique”⁴⁶ and the work of the FASB Options Valuation Group has not been used to establish such a preference. The entity is responsible for establishing reasonable and consistent assumptions and estimates⁴⁷ in the course of using a valuation technique and is expected to change techniques on a prospective basis if the new choice is likely to result in a “better estimate of fair value.”⁴⁸

Estimation of fair value in the case of ESOs is considered difficult in part because of the lack of a traded market in the instruments and the restrictions that the terms of the instruments represent, which some financial economists believe should affect the fair value estimate. FASB Statement No. 123(R) provides for this difficult setting when noting that “*restrictions* and conditions inherent in equity instruments awarded to employees are treated

43. FASB Statement No. 123(R), paragraph A18.

44. FASB Statement No. 123(R), paragraph A12.

45. See FASB Statement No. 123(R), paragraph A13.

46. FASB Statement No. 123(R), paragraph A14.

47. FASB Statement No. 123(R), paragraphs A23 and A24.

48. FASB Statement No. 123(R), paragraphs A17 and A23.

differently depending on whether they continue in effect after the requisite service period” (that is, the vesting period). For example, the “inability to transfer *vested* equity share options to third parties or the inability to sell vested shares . . . is considered in estimating the fair value [of the ESOs and the] effect of nontransferability and nonhedgeability . . . is taken into account ...[in] an option’s *expected term*.”⁴⁹ By contrast, the notion that ESOs may be forfeited before the ESO rights have been earned (presumably some time before the end of the vesting period or in certain cases, loss of employment) is addressed by FASB Statement No. 123(R) by “recognizing compensation cost only for awards for which employees render the requisite service.”⁵⁰

SAB No. 107 provides further implementation guidance on ESO valuation using fair value models (see the following section). FASB Statement No. 123(R) also includes several examples to demonstrate its accounting policies with special attention paid to valuation considerations. In addition, Appendix A of FASB Statement No. 123(R) and SAB No. 107 address certain limitations to valuation techniques and manners in which to address such limitations within the measurement goals of FASB Statement No. 123(R).

Balance Sheet Classification of ESO instruments

The expense or cost of the ESO instrument is recorded in the income statement, according to the provisions of FASB Statement No. 123(R). The offset to the recognition of cost is a balance sheet account that recognizes the existence of the derivative contract (much as FASB Statement No. 133 requires balance sheet recognition of all derivative instruments within its scope). ESO transactions may be classified as a liability or as a component of equity, depending on the circumstances surrounding the transaction.

The reader must examine the details of the ESO contract arrangement and follow the detailed rules within FASB State-

49. FASB Statement No. 123(R), paragraph 17. For the terms that are in *italics* please refer to the Glossary in FASB Statement No. 123(R).

50. FASB Statement No. 123(R), paragraph 18.

ment No. 123(R) to arrive at the proper classification (see paragraphs 29 through 35 of FASB Statement No. 123(R) and, where applicable, references to other FASB guidance, including FASB Statement No. 150). These classification provisions provide specific guidance on the following types of ESO arrangements:

1. A call option on another instrument classified as equity.
2. Puttable or callable shares requiring the employer to repurchase them.
3. Options that are indexed to shares that are classified as liabilities.
4. Certain option settlement provisions that will require that the ESO instruments are settled in cash.
5. Options with certain indexing to market factors other than an underlying equity instrument.
6. Certain conditions or the occurrence of contingent events, under which the substantive arrangement of the ESO contract calls into question the issuing entity's ability to deliver the equity shares when the ESO is exercised or requires cash settlement.
7. Certain provisions requiring the employer to withhold part or all of an award.
8. A broker arrangement permitting the employee to execute a "broker-assisted cashless exercise."⁵¹

Timing for the Recognition of Compensation Cost

Generally FASB Statement No. 123(R) treats the requisite service period (RSP) as the vesting period in the ESO contract. If the RSP extends over more than one reporting period, the accounting should reflect not only the recognition of the ESO cost but also the RSP; the cost of the ESO should be matched to the RSP. FASB Statement No. 123(R) also contains detailed guidance on how to estimate the RSP.

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51. FASB Statement No. 123(R), paragraph 35.

If the ESO Is Accounted for as an Equity Instrument. If the ESO is classified as equity, the compensation cost is “recognized over the [RSP], with a corresponding credit to equity (paid-in capital).”⁵² In addition, “previously recognized compensation cost . . . is not reversed . . . if the [RSP has ended and the instrument] expires unexercised (or unconverted).”⁵³

Paragraphs 51 through 57 of FASB Statement No. 123(R) also provide guidance on how to account for modification of ESOs that are treated as equity instruments. Modifications are “treated as an exchange of the original award for a new award.”⁵⁴ Examples of some of the modifications covered include inducements, equity restructurings, repurchases or cancellations of awards, and cancellation and replacement of awards.

If an ESO Is Accounted for as a Liability Instrument. Changes in fair value (or the value used for FASB Statement No. 123(R) recognition purposes) after the grant date and during the RSP for an ESO accounted for as a liability should be recognized as compensation cost over that RSP. Changes in fair value (or the value used for FASB Statement No. 123(R) recognition purposes) after the RSP for an ESO accounted for as a liability should be recognized as compensation cost in the period in which the changes occur.

FASB Statement No. 123(R) Share-Based Payments and Taxation

Paragraph 58 of FASB Statement No. 123(R) summarizes the tax issues and related accounting that are relevant to the ESO issuer.

Income tax regulations specify allowable tax deductions for [ESO] instruments. [As of December 2004 . . . IRS regulations allowed] tax deductions . . . [for the] intrinsic value of [the ESO] on a specified date.

The treatment for timing differences that arise due to differences in tax law as compared with GAAP require application of FASB

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52. FASB Statement No. 123(R), paragraph 39.

53. FASB Statement No. 123(R), paragraph 45.

54. FASB Statement No. 123(R), paragraph 51.

Statement No. 109, *Accounting for Income Taxes*. There are other potential GAAP reporting issues that may arise due to differences between the GAAP and tax treatment of ESOs, over the period ranging from the grant date to the expiration date, which are described in paragraphs 59 through 63 of FASB Statement No. 123(R), and illustrated in that Statement’s Appendix A.

Required Disclosures

Reporting entities must disclose for each share-based arrangement. According to paragraph 64 of FASB Statement 123(R):

- a. The nature and terms of [the arrangement] . . . and the potential effects on shareholders
- b. The effect of compensation cost [of the arrangement] on the income statement
- c. The method of estimating the fair value of the goods or services received, or the fair value of the equity instruments granted [under the arrangements] during the period
- d. The cash flow effects [from the arrangements].⁵⁵

Additional guidance is contained in paragraphs 64, 65, A240, and A241 of FASB Statement No. 123(R).

EPS Implications

Under FASB Statement No. 128, *Earnings per Share*, share-based arrangements covered by FASB Statement No. 123(R) must be treated as “potential common shares in computing diluted earnings per share”⁵⁶ with some conditions and exceptions. See paragraphs 30 to 35 of FASB Statement No. 128 for additional guidance on “contingently issuable shares” and paragraphs 21 through 23 for guidance on “the treasury stock method for equity instruments.”⁵⁷

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55. FASB Statement No. 123(R), paragraph 64.

56. FASB Statement No. 123(R), paragraph 66.

57. FASB Statement No. 123(R), paragraphs 66 and 67, respectively.

Appendix B to this Alert contains a listing that can be used as an index to the examples and illustrations contained in FASB Statement No. 123(R).

Section IV: What Are the Likely Effects of FASB Statement No. 123(R)?

The issuance of FASB Statement No. 123(R) has resulted in significant alteration in compensation behavior. The FASB Statement No. 123(R) requirement to expense ESO compensation will most likely lead to a substantial reduction in the use of the ESO contracts, a trend to less favorable contract terms, and the evolution of financial engineering and accounting measurement technology to facilitate the measurements required by FASB Statement No. 123(R).

ESO contracts are being replaced by restricted stock, issued with less favorable terms, or deleted from entity compensation plans entirely. There is now a decreased likelihood that ESOs will be a pervasive uncontrolled form of enrichment. At the same time, younger high tech companies may now be more reluctant to use ESOs as a means of retaining high quality talent.

It should come as no surprise that the pace of innovation in financial engineering for ESO valuations has quickened since FASB Statement No. 123(R) was issued. Now that fair value calculations are mandatory for ESOs, improved valuation models are being announced. Most important, the responsibility for creating a suitable valuation methodology has migrated from financial economists to accountants and auditors.⁵⁸ The SEC has facilitated this valuable improvement in knowledge through some of the valuation guidance contained in SAB No. 107.⁵⁹

The end of the antiexpensing debate and the new period of financial engineering have also seen a renewed consideration of

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58. See the recent financial engineering work on ESOs by Louis P. Le Guyader (www.kerlouet.com).

59. See the recent work by Mark Rubinstein (www.in-the-money.com) and that of Shoven and Bulow (www.stanford.edu).

improvements to accounting policy for ESOs, including some proposed amendments to FASB Statement No. 123(R) that have been presented to the SEC and the FASB.⁶⁰

Section V: Summary of SEC SAB No. 107

On March 29, 2005, the SEC Staff, acting through the Office of the Chief Accountant and the Division of Corporation Finance, issued SAB No. 107 to provide “guidance regarding the application of . . . FASB Statement No. 123(R).” The SEC staff issued SAB No. 107 as an effort to explain and simplify the detailed technical provisions of FASB Statement No. 123(R), especially the guidance on fair value measurement, which incorporates the current GAAP measurement guidance of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and the implementation experience of other standards on financial instruments. Below is a summary of the key provisions of SAB No. 107, with emphasis on the guidance that should be applied to the fair value measurement process for stock options. A full copy of the text is available for download on the SEC Web site at www.sec.gov.

A Summary of Stock Option Accounting Under FASB Statement No. 123(R), as Interpreted by SAB No. 107

Stock option expensing covers three major topics:

1. The determination of what constitutes compensation for accounting purposes.
2. The accounting policy for the recognition of compensation costs.
3. The measurement principles that should be used to arrive at that cost.

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60. See the recent accounting work on ESOs by Louis P. Le Guyader (www.kerlouet.com) and the Columbia University CEASA Policy Papers by James A. Ohlson and Stephen Penman.

SAB No. 107 interprets FASB Statement No. 123(R) to require that any compensation for services provided by employees be recognized as a cost in the financial statements, and to eliminate past accounting practices to defer compensation on the balance sheet *before* services are provided.

The effect of FASB Statement No. 123(R) and SAB No. 107 is that if an SEC issuer uses any form of stock options in lieu of cash payments to employees for services rendered, the cost of the stock options is measured on the grant date at their fair value, and charged to earnings over the period of time that the compensated services are provided. In releasing SAB No. 107, the SEC staff's goal was to assist SEC issuers in their implementation of FASB Statement No. 123(R), thereby improving the quality of the accounting information given to investors and other users of accounting information. The following table summarizes the topics addressed by SAB No. 107.

Principal Topics Covered by SAB No. 107

1. Use of FASB Statement No. 123(R) for nonemployee transactions.
 2. Nonpublic entities that become public.
 3. Valuation methods.
 4. Assumptions used in valuation methods.
 5. FASB Statement No. 123(R) and certain redeemable financial instruments.
 6. Classification of compensation expense.
 7. Non-GAAP financial measures.
 8. First-time adoption of FASB Statement No. 123(R) in an interim period.
 9. Capitalization of compensation cost.
 10. Accounting for income taxes.
 11. Modification of stock option contracts before the adoption of FASB Statement No. 123(R).
 12. Foreign private issuers.
 13. Management's discussion and analysis disclosures after the adoption of FASB Statement No. 123(R).
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The SEC staff has been well versed in the complexities of other implementation periods for accounting standards on financial instruments or those standards requiring software to enable

implementation.⁶¹ SAB No. 107 therefore uses the notion of a “reasonable” range of actions to comply with the valuation requirements of FASB Statement No. 123(R). Indeed, the opposite would be cause for concern: It is unlikely that any singular valuation method to determine the fair value of stock options would be so preferable as to cause the SEC to dispose of alternative methods as “incorrect” or “wrong.” Nonetheless, the flexibility of implementation that the SEC staff has extended is meant to apply to the initial implementation period of FASB Statement No. 123(R). The SEC expects that, as with any other business process, over time the range of choices and reasonable actions will narrow and “best practices” will emerge.

Summary of Key SAB No. 107 Guidance

Use of FASB Statement No. 123(R) for Nonemployee Transactions

FASB Statement No. 123(R) is not meant to supersede existing GAAP for nonemployee transactions. In general, if a particular nonemployee share-based payment transaction does not appear to be specifically governed by GAAP, selected FASB Statement No. 123(R) provisions can be used as analogies to account for such transactions.

Nonpublic Entities That Become Public

A private company (a nonpublic entity) may measure its liabilities under stock options at their intrinsic value under FASB Statement No. 123(R) as described in paragraph 38 or select the alternative “calculated value,” as described in footnote 23 to

61. The provisions of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, were postponed to allow time to complete software development. A similar need for systems support led the FASB to postpone the effective date for FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, which became the primary reason for FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133—an amendment of FASB Statement No. 133*. FASB Statement No. 133 then was amended a total of four times in the hope of perfecting the accounting implementation. The issuance of FASB Statement No. 123(R) resulted in further modifications to FASB Statement No. 133.

FASB Statement No. 123(R) and paragraphs A43 through A48. The choice of intrinsic value given to nonpublic entities “is an exception from what the [FASB] considers to be” a preferable measurement method. (see paragraph B142). However, nonpublic entities retain the choice to use “fair value [that] is the conceptually preferable measurement attribute” (see paragraph B143). The SEC’s SAB No. 107 highlights the special case of “nonpublic entities” that are transitioning to “public entity” status (see the Glossary of FASB Statement No. 123(R) for definitions of those terms). For share options that are granted prior to the date it becomes a public entity, and for which the nonpublic entity had selected the calculated value method, the SEC staff believes the entity should continue to use that approach. If the share options are subsequently modified, repurchased, or canceled by the public entity, the form of the change should be evaluated under FASB Statement No. 123(R). Under the appropriate circumstances, any incremental compensation cost would be measured under fair value. If on the other hand the nonpublic entity had issued stock options that are liability awards accounted for using intrinsic value (which is not preferable to fair value), then upon the date the entity becomes a public entity, it should measure the liability awards at their fair value. The public entity, however, may not retrospectively apply the “fair-value-based” approach to awards granted prior to the date it becomes public (see SEC SAB No. 107, Section B). The entity must also disclose in public filings any change in measurement policy and the basis for value estimation in management’s discussion and analysis (MD&A). Such disclosure should also conform to other SEC policies.

Valuation Methods

The objective of FASB Statement No. 123(R) is to measure stock options at the grant date, which is the earliest possible date, using the fair value, which is the most reliable measure for financial instruments accepted by GAAP. Since observable market prices for stock options, or similar financial instruments, are not available as the best evidence of fair value, SEC issuers must rely on a “second best” fair value. SEC issuers are therefore expected

to estimate the fair value using a valuation technique also known as the mark-to-model approach.

The value of an ESO can reasonably be expected to change from the grant date to the expiration date (or exercise date) as market factors including the underlying stock price and expectations about the future changes in the stock price of the issuer change over time. The fair values used for reporting should be proxies for the actual price that would be paid for the stock options. It is possible that good faith estimates may significantly differ from the settlement value of the stock options.

FASB Statement No. 123(R) does not specify any one valuation method as preferable. Any valuation technique used must satisfy three characteristics to meet the fair value measurement objective:

1. The method used must be applied consistently in conformity with FASB Statement No. 123(R).
2. The method must be based upon established principles of financial economics theory as generally applied in that field.
3. The method must reflect all substantive characteristics of the stock option instrument.⁶²

The SEC staff has indicated that SEC issuers will be granted flexibility in selecting models as long as each of these three characteristics has been met. Therefore, an SEC issuer does not necessarily have to select the most complex valuation model because the SEC would not object to the use of other models that meet the aforementioned characteristics. Third-party or expert valuation is neither required nor expected. However, the entity should acquire the requisite expertise to value the stock options.

Future changes in valuation methods (techniques or models) are permitted within the reporting goals of FASB Statement No. 123(R). This type of change would not be considered a change in

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62. In general, the reader can think of “substantive characteristics” to include any term of the financial contract that would affect its valuation in efficient markets under normal circumstances.

accounting principle and would not require a preferability letter from its independent accountants; disclosure of the change would, however, be appropriate. The SEC staff warns that frequent changes would not be expected.

Assumptions Used in Valuation Methods

FASB Statement No. 123(R) discusses two specific technical terms used in the accounting rules for stock options: expected volatility and expected term.

Expected Volatility. Some option models, such as the Black-Scholes-Merton model, use a parameter known as volatility, which is a measure of how much an entity's stock price changes (equity prices are the option's "underlying market factor").⁶³ Volatility can be estimated, depending on the circumstances, in forms known as implied volatility and historical volatility. Expected volatility is the estimated future volatility of equity prices for use in valuation models.

FASB Statement No. 123(R) does not specify how to measure expected volatility. The estimate used by the SEC issuer should be a "likely" match to the estimate that a marketplace participant would use. The SEC staff believes that SEC issuers should use best faith estimates to identify and use sufficient information, including implied volatility, historical volatility, or both measures, to estimate expected volatility.

Implied volatility. This is the volatility assumption inherent in the market prices of an entity's traded options or financial instruments with characteristics similar to options. SEC issuers are reminded that implied volatility is likely to be a suitable measure if the SEC issuer has other equity instruments traded in the market, including options and embedded options. The estimation process should be applied consistently; however, if new or different information becomes available that is relevant to estimating the

63. *Market factor* is a term used by the SEC in FR-48, "The Market Risk Rule." Market factors include interest rates, foreign exchange rates, commodity prices, and equity prices.

expected volatility, this information should be incorporated into the model.

If traded options are used to estimate expected volatility, the following should be considered in evaluating the market data:

1. The volume of market activity in the underlying shares and traded options.
2. The ability to “synchronize” variables used to derive implied volatility by selecting prices from markets trading at similar times and by measuring volatility as close as possible to the grant date of each series of options.
3. The similarity of the exercise price and term length of the traded options to the exercise price and term length of the employee stock options.

Historical volatility. SEC issuers who estimate expected volatility by computing historical volatility should consider the period of time over which volatility is calculated—either the estimated or contractual term of the options—and should also note the following:

1. Weighing more recent periods more heavily than earlier periods in contracts with long terms may not be appropriate.
2. Use of other periods of time, other than the expected or contractual term of the option, to derive the estimate of volatility is admissible if it results in improving the estimate.
3. The intervals over which data is taken to form the estimate must be “appropriate and regular.”
4. The selection of the frequency in data points must be sufficient to provide enough data points.
5. A consistent point in time within each interval should be selected.
6. The selection and use of data should be sensitized and adjusted to consider future events that would alter the volatility estimate.

In rare cases, a certain period of time may be excluded from the data; if any such exclusion exists, the SEC issuer must be prepared to support this statistical decision.

It is expected that SEC issuers could, in certain circumstances, reasonably conclude that exclusive reliance on either historical or implied volatility would provide an estimate of expected volatility that meets the measurement objectives of FASB Statement No. 123(R). FASB Statement No. 123(R) contains a list of factors that SEC issuers should consider in this regard; SAB No. 107 contains further criteria for the SEC issuer to consider if intending to rely on only either implied volatility or historical volatility.

FASB Statement No. 123(R) requires the SEC issuer to disclose the expected volatility and the method used to establish it. The SEC staff expects the disclosure to include whether implied volatility, historical volatility, or some combination of both is used to derive expected volatility. In addition, the SEC issuer is expected to satisfy the requirements of other SEC disclosure rules regarding critical accounting estimates, such as SEC Release No. FR-60, "Cautionary Advice Regarding Disclosure About Critical Accounting Policies." and SEC Release No. FR-72, "Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations," by including an explanation of the method used, and the basis for the company's conclusions.

Other methods of estimating expected volatility are acceptable, assuming the SEC issuer includes appropriate adjustments as detailed in the full text of SAB No. 107. The overall goal is for each SEC issuer to use an expected volatility estimate that as closely as possible suits the volatility that the market ascribes to its securities, thereby achieving the measurement objectives of FASB Statement No. 123(R).

Expected Term. The FASB documented its opinion that the expected term of stock options should be the assumed basis for the fair value estimates on the ESO contracts. The contractual term is not used, since the option holder typically exercises the option

before the end of the option's contractual term. The expected term is a valuation parameter that can capture the effects of non-hedgability, nontransferability, and forfeitability of stock options. In such cases where the expected term captures these effects, no other adjustments to the valuation parameters are needed. The expected term, however, may not be shorter than the vesting period of the option contract; the end of the vesting period coincides with the first possible exercise date and this date would represent the shortest time span that the options can exist.

The complexity of valuing financial instruments can be overcome by placing similar instruments in groups and applying the valuation techniques to the group as a whole. The SEC staff believes that this can be accomplished for an entity that frequently grants options with as few as one or two groups. Approaches to estimating the expected term are considered reasonable if they result in an option fair value that is an equivalent to an "exchange price" for the option. Subsequent changes to the term estimates may be reasonable if new evidence is found; changes would not invalidate the reasonableness of the original expected term assumption.⁶⁴ SAB No. 107 details additional comparative information that might, if used, contribute to estimates of the expected term, when a company determines that its historical stock option exercise activity does not provide a reasonable basis for the estimate of the expected term.

The SEC staff recognizes the following terms as "plain vanilla" stock option terms:

1. Options are granted at-the-money.
2. Exercisability depends only on the employee performing the necessary services through the vesting period.
3. Employment termination before vesting results in option forfeiture.

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64. *Expected term* in the case of FASB Statement No. 123(R) is similar to *expected maturity* as it is used in FR-48, "The Market Risk Rule."

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4. Employment termination after vesting results in a limited time to exercise the stock options.
 5. The options are nontransferable and nonhedgeable.

If a company has issued plain vanilla stock options and chooses not to rely on historical exercise data, the SEC staff would accept a “simplified” method for estimating the expected term:

$$\text{Expected Term} = (\text{Vesting Term} + \text{Original Contract Term})/2$$

Once elected, the simplified method must be applied consistently to all “plain vanilla” stock options and this choice should be disclosed in the financial statement footnotes. The SEC staff expects that a sufficient amount of market data on stock options exercises will become available over time, so that the simplified method would not be used after December 31, 2007.

FASB Statement No. 123(R) and Certain Redeemable Financial Instruments

SEC issuers must evaluate whether stock options should be presented as liabilities under FASB Statement No. 123(R), or alternatively, as either equity or outside of permanent equity (also known as “temporary equity”) in accordance with SEC Accounting Series Release No. 268, *Presentation in Financial Statements of “Redeemable Preferred Stocks”* (ASR 268) and related guidance. Certain redeemable financial instruments may cease to be governed by FASB Statement No. 123(R) because “the rights conveyed by the instrument to the holder are no longer dependent on the holder being an employee of the entity.” In this instance, the financial instruments should be reviewed for application of ASR 268 or other accounting rules under GAAP.

If an instrument qualifies for recognition as temporary equity, the amount that should be presented as temporary equity is generally equal to the fair value of the instrument multiplied by the percentage vested.

Classification of Compensation Expense

The compensation expense to employees from stock options, even if a noncash amount, should be reported in the income

statement on the same line as the cash basis salary paid to those employees. There is no guidance given as to the exact line item in the income statement that should be used to disclose these amounts. Separate disclosure to highlight the location and amount of compensation expense related to share-based payment transactions may be appropriate.

Non-GAAP Financial Measures

SEC issuers may wish to provide a non-GAAP measure of earnings in which the cost of stock options is excluded from net income; such disclosures must abide by the provisions of Regulation G and Item 10(e) of Regulation S-K. If such non-GAAP measures are shown, the SEC issuer must demonstrate the usefulness of excluding stock option expenses to the extent that they are nonrecurring items; the disclosure should not be used as an attempt to smooth earnings. If the stock option expense is excluded from the entity's internal accounts to evaluate performance, the SEC issuer may have a basis to conclude that the exclusion of the expense in a non-GAAP measure disclosure satisfies the requirements of Item 10(e) of Regulation S-K. In such cases, disclosures should include both the reason for the presentation of the non-GAAP financial measure and, if material, the additional purposes for using that measure within the entity. SEC issuers should also consult the June 2003 SEC document *Frequently Asked Questions Regarding the Use of Non-GAAP Measures* to confirm that the disclosures are not misleading.

In MD&A, SEC issuers should discuss the trends and variability of the entity's earnings and analyze specific line items if it is relevant to understanding a company's performance. Such narratives may be especially helpful in the case of noncash expenses from stock options that are likely to be nonrecurring. The SEC issuer must also be aware of certain prohibitions in FASB Statement No. 123(R) and SEC rules regarding the exclusion of stock option expense in pro forma income statements.

First Time Adoption of FASB Statement No. 123(R) in an Interim Period

This section of SAB No. 107, issued on March 29, 2005, has largely been superseded by the April 14, 2005, announcement from the SEC Chief Accountant that the effective date of FASB Statement No. 123(R) would be postponed to the start of fiscal years beginning on or after June 15, 2005.

SEC issuers are not permitted to apply FASB Statement No. 123(R) retrospectively. This means that in general, cumulative effects adjustments should be recorded on the date of adoption of FASB Statement No. 123(R), and *not* any date before the adoption date (including the beginning of the fiscal year in which adoption occurs).

While the action of the SEC Chief Accountant postpones the required effective date of FASB Statement No. 123(R), SEC issuers may still early adopt the provisions of FASB Statement No. 123(R).

Capitalization of Compensation Cost

SEC issuers may accumulate inventory costs during a manufacturing process in the form of compensation paid through stock options. SAB No. 107 states that:

1. Deferral of FASB Statement No. 123(R) costs through inventory accounts is expected as long as the costs are properly reflected in subsequent periods through earnings, normally through cost of sales; this deferral process is consistent with the matching principle and relies on inventory accounting rules outside of FASB Statement No. 123(R).
2. Inventory tracking systems that predate FASB Statement No. 123(R) may not be able to incorporate FASB Statement No. 123(R) costs at the same level of detail as more recent stock compensation costs. A period-end adjustment to the overall inventory balance for FASB Statement No. 123(R) costs would be acceptable and would not in itself negate the claim that internal controls are effective,

as required by the SEC's rules implementing Section 404 of the Sarbanes-Oxley Act of 2002 (see SEC Release No. 34-47986).

Accounting for Income Taxes

If the entity deducts more in compensation costs for tax purposes than for financial reporting purposes, any resulting excess tax benefits must be reported as additional paid-in capital. If current period tax deductions are less than the cumulative compensation cost reported for financial reporting, the entity should write off the deferred tax asset, net of any valuation allowance, against any remaining additional paid-in-capital from previous awards. The remaining balance of the write-off, if any, should be recognized in the income statement. Thus, FASB Statement No. 123(R) necessitates the tracking of tax attributes relating to share-based payment transactions. FASB Statement No. 123(R) does not specify the date that the entry to additional paid-in capital should be calculated, though the SEC notes that the calculation would not be required on the date FASB Statement No. 123(R) is adopted. FASB Statement No. 123(R) also does not require disclosure of the additional paid-in capital available for offset; the SEC notes that a company only needs to calculate the additional paid-in capital available for offset when the company's deductions per the tax return are less than the relevant deferred tax asset, and to ensure that a sufficient amount of paid-in capital is available for the offset of the deduction shortfall.

Modification of Stock Option Contracts Before the Adoption of FASB Statement No. 123(R)

Under certain circumstances, the earnings' impact on some stock options under FASB Statement No. 123(R) can be mitigated if those contracts are modified before the adoption of FASB Statement No. 123(R) by accelerating the vesting date. The SEC interprets FASB Statement No. 123(R) to mean that this specific modification would result in the recognition of the remaining amount of the compensation cost in the period in which the modification is made. The test of whether such a modification

has been made is if the employee could exercise the options after the modification, whereas before the modification he or she could not. Since the entire amount of the compensation cost would have been recognized under rules in effect before the adoption of FASB Statement No. 123(R), no further cost would be recognized in the income statement after adopting FASB Statement No. 123(R). Significant modification of option terms necessitates disclosures of the terms of the modifications and the reasons for the modifications, particularly if a company accelerates the vesting of out-of-the-money options before adopting FASB Statement No. 123(R).

Foreign Private Issuers

The SEC staff believes that application of the measurement provisions of International Financial Reporting Standard No. 2, *Share-Based Payment*, would result in a fair value measurement that is consistent with the fair value objective of FASB Statement No. 123(R). Thus, reconciling items between International Financial Reporting Standards and U.S. GAAP should typically not occur within the guidelines of SEC Form 20-F, though certain other reconciling items may still in fact occur.

MD&A Disclosures After the Adoption of FASB Statement No. 123(R)

An SEC issuer may use different accounting policies subsequent to the adoption of FASB Statement No. 123(R) than with previous applicable rules for stock option accounting reflected in Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*; FASB Statement No. 123, *Accounting for Stock-Based Compensation*; and FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123*. Also, changes to measurements required by FASB Statement No. 123(R) may occur as SEC issuers refine their ability to form assumptions and estimates. Both differences may result in material changes to the SEC issuer's financial statements over time and so affect the comparability of financial statements.

SEC issuers should consider including the following MD&A disclosures:

- The transition method selected and the financial statement impact in current and future reporting periods.
- The accounting method for stock options before adoption of FASB Statement No. 123(R), and the impact, or lack of impact, on the prior financial statements.
- Modifications made to stock options before adoption of FASB Statement No. 123(R) and the rationale behind such modifications.
- Differences in valuation methodologies or assumptions used to estimate fair value upon adoption of FASB Statement No. 123(R), as compared to the methodologies or assumptions previously used.
- Changes in quantity or type of instruments used in share-based plans (for example, changes from stock options to restricted shares).
- Changes in the terms of share-based payment arrangements.
- Discussion of any one-time effect upon the adoption of FASB Statement No. 123(R), such as any cumulative adjustments.
- Total compensation cost for nonvested awards that are not yet recognized and the weighted average period over which the nonvested awards are expected to be recognized.

Special Topics

Receivables From Sale of Stock

When capital stock is issued to the entity's officers in return for a receivable before cash payment is made, the receivable is deducted from equity and is not presented as an asset, as consistent with Rule 5-02.30 of Regulation S-X; the requirement remains to separately list those receivables in the balance sheet.

Accounting for Expenses or Liabilities Paid by Principal Stockholder(s)

If a company is named as a defendant in litigation, and a principal stockholder transfers a portion of his or her shares to the plaintiff in order to settle such litigation, the value of the shares transferred should be recorded as an expense in the company's income statement and as a credit to additional paid-in capital. The SEC staff believes that the substance of such a transaction is the payment of a company expense through contributions by a stockholder, and that such accounting treatment is in accordance with the provisions of paragraph 11 of FASB Statement No. 123(R).

Section VI: What Is the Value of a Stock Option?

While SAB No. 107 provided guidance on a variety of topics related to FASB Statement No. 123(R), much of the guidance in SAB No. 107 focused on assumptions used in fair value methodologies; this section will further explore fair value accounting for ESOs, as required by FASB Statement No. 123(R) and SAB No. 107. An in-depth discussion of fair value accounting is necessary, as a complete implementation of FASB Statement No. 123(R) requires the understanding of how accounting entries related to FASB Statement No. 123(R) incorporate the use of fair value estimates, what the estimates represent, and the validity of the valuation methodology that is used to derive the estimate.

The Debits and Credits for ESO Fair Values

The most basic accounting entry related to FASB Statement No. 123(R) would be to record the entire ESO fair value estimate as an expense, or debit, and to record a balancing credit in equity (or in some cases liabilities). Therefore, if an ESO's grant-date fair value is determined to be \$200, the required entry would be to debit compensation cost for \$200 and to credit an employee stock option liability account (or, depending on the circumstances, an equity account) for \$200.

A subtle aspect of FASB Statement No. 123(R) is that in cases in which the ESO is to be recorded in the equity portion of the balance sheet, the fair value will not be remeasured.⁶⁵ In these cases, the measurement process is greatly simplified and conducted on only one date, the ESO grant date.

The use of the grant-date as the proper time to recognize the cost of the ESO in the financial statements reflects the FASB's objective of recognizing the value of contractual compensation arrangements in the financial statements. It also reflects the goal of applying recognition criteria for financial instruments consistently. The use of the grant date to recognize ESOs is consistent with the requirement to recognize other classes of derivatives on the analogous date: the start date for swaps, the purchase date for exchange traded futures and options, and the transaction date for forwards and over-the-counter options. The use of the grant date for recognizing compensation cost is also consistent with the policy of recognizing securities on the trade or acquisition date, not the settlement date.

The overall valuation methodology must consider all the critical terms of the ESO derivative contract through its expiration date.⁶⁶ The valuation methodology also needs to use the best estimate of each parameter on the grant date. For example, the use of a volatility estimate that is two years old for a current valuation would not be appropriate; also, the use of interest rate and volatility estimates from different periods would possibly lead to

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65. In the complete form of fair value accounting for a financial instrument, the instrument is recognized at its fair value when purchased, if exchange traded, or created, or if in the form of a principal-to-principal contract. At each subsequent reporting date, the fair value is updated and changes from the original fair value (so-called fair value flows) are recorded in income (either earnings or other comprehensive income). The updating of the fair value measure is generally the same as marking-to-market or remeasurement. Various permutations of fair value accounting for financial instruments are found in FASB Statement No. 115 and FASB Statement No. 133. Fair value notions are also used throughout GAAP to record the cost of an asset or liability on the date it is acquired or to restate carrying amounts on the balance sheet to the lower-of-cost-or-market (LCM) when a permanent impairment of the item's fair value has occurred.

66. It is understood that a "critical term" is one that is value-relevant—the decision to include it or exclude it from the valuation methodology alters the fair value estimate itself.

an estimation error. As a result the valuation methodology must be robust enough to capture all contract terms and yet be flexible enough to use parameters that can be retrieved efficiently. The methodology also must be verifiable.

ESO Fair Value Within the GAAP Definition of Fair Value

SAB No. 107 explains that the ESO fair value measurement should be the equivalent of an exchange price for the ESO. Some consider this to be an unrealistically high measurement standard because ESOs are more illiquid than most over-the-counter derivatives contracts; they are principal-to-principal contracts that are not traded, not transferable, and not hedgeable. Because no current price exists for ESOs, the issuing entity must rely on a mark-to-model methodology. FASB Statement No. 123 explained that the fair value of ESOs could be extracted from option models such as the Black-Scholes-Merton Option model. More recently binomial models have been highlighted as an effective alternative.⁶⁷

Neither the FASB nor the SEC has selected any one model or approach as the most suitable approach for the measurement tasks within FASB Statement No. 123(R). Experts continue to disagree, and change their opinions, as they consider approaches that might meet the SEC goal of estimating fair values that are, in effect, exchange prices.

The full fair value of the ESO can change over time as the entity issues new contracts. In SAB No. 107, the SEC recognizes that the market's skill in valuing ESOs will increase once FASB Statement No. 123(R) is implemented. In some cases, the full fair value is not used if the entity's own stock (the underlying) is not traded in an exchange market, as is the case for private companies. The absence of a public market in the private entity's stock is

67. During the deliberations for FASB Statement No. 123(R), the FASB established the Options Valuation Group, which met with the FASB to provide information on the choice of and operation of various methodologies. At various times in the last 15 years of ESO deliberations that led to the issuance of FASB Statement No. 123(R), the FASB has also met with leading academic financial economists who are experts in the use of option valuation tools.

an example of the setting that may cause estimating the expected volatility of the entity's stock to be impracticable. The alternative measures for fair value permitted under FASB Statement No. 123(R) discussed elsewhere in this Alert can then be used as a fair value for reporting purposes if the appropriate conditions for such a substitution are met.

Valuation Methodologies: The Accounting and Auditing Approach Compared to the Financial Engineering Approach

The Financial Engineering Approach

This is a valuation methodology that relies on a mark-to-model approach using any one of a number of models and associated estimates of parameters that the entity in its judgment believes is suitable to its form of ESO contract and that achieves the measurement objective of FASB Statement No. 123(R) of estimating the equivalent of an ESO exchange price. Examples of those approaches include “closed form” solutions such as the family of models within the Black-Scholes-Merton models, the lattice models that include the binomial model, and separate methods of estimating parameters such as expected maturity and expected volatility that are needed to operate these models.

The difficulties in applying these methods are numerous: public policy issues, limits on the use of the financial economic theory underlying the valuation methodology, and the apparent inability to achieve an “exchange price equivalent.”

Public Policy Issues. Substantial arguments were displayed to the FASB to discourage the financial statement recognition of ESOs due to the perceived inability to value the derivatives with sufficient quality to justify placement in the financial statements. SAB No. 107 must be consulted for guidance on how to implement FASB Statement No. 123(R) using models that are “flawed but the best available.” SAB No. 107 also gives guidance on how to migrate to improved methods over time and reconcile future values based on those improved methods to weaker methods used at the effective date of the standard.

Limitations on Available Financial Economic Theory. Existing financial economics has taken the approach that existing models or attempts to modify those models for the purpose of ESO valuation are producing superior valuations as compared to the simple and unadjusted use of basic option pricing methods. A consistent observation is that the resulting values, at least at grant date, are high as compared with the valuation experts' "economic intuition" of a preferred but as-yet unsubstantiated fair value. However, there is also uniform agreement that the specific contract provisions of ESOs result in many potential valuation errors, with only limited narrowing since December 2004, when FASB Statement No. 123(R) was released.

Inability to Achieve a Verifiable "Exchange Price Equivalent." The continued dialogue within the financial engineering community is that even a new class of improved valuation methodologies continues to fall short of an "exchange price equivalent." Only one valuation technique has the attribute that Wall Street traders, not valuation experts, have informally considered it a replication of the pricing methodology that is performed on their trading desks.⁶⁸

While the FASB considered the advice of the Options Valuation Group to formulate the fair value guidelines in FASB Statement No. 123(R), it declined to specify any one model as the best alternative, nor would it list the models that may be considered suitable for the entity. FASB Statement No. 123(R) only specifies that the methodology must rely either on current prices (which are not available for ESOs as well as the similar assets that might be used as proxies) or a model that applies fundamental principles of "financial economic theory . . . [that] are generally applied in that field."⁶⁹

The Accounting and Auditing Approach

Accountants often describe the fair value of an option as having two parts:

68. See Le Guyader paper, "A Simple Way to Recognize Stock Options at Fair Value in Income" (2006) available at www.kerlouet.com.

69. See FASB Statement No. 123(R), paragraph A13.

Fair Value FOR ANY OPTION = [Time Value + Intrinsic Value]MAX VALUE ZERO⁷⁰

The accounting formula applies to any option regardless of the complexity of the option contract or the nature of, or lack of, the “price discovery” system for the contract as a financial instrument.⁷¹ Many financial instrument portfolios contain illiquid positions in derivatives and other financial instruments. The valuation issues in this instance are identical to those presented by ESOs. In both cases current exchange prices do not exist, broker confirmations are not available, and standard financial engineering approaches fail (see below).

Unlike other option contracts, the intrinsic value will not be realizable until the vesting date. On the date the ESO option holder chooses to exercise, the time value becomes irrelevant and one can think of the option value as being its intrinsic value, even if that value is zero. The fair value of the ESO might become much greater than the grant date fair value if the option becomes in-the-money (for instance, early during the exercise period, when there is still substantial time value). Conversely, the fair value of the ESO may be zero by the time the expiration date is reached, in the case when the ESO is both out-of-the-money and not exercised, as there would be no time left to allocate to the time value estimate.

The grant-date fair value will normally entirely reflect time value as ESOs are written at-the-money or out-of-the-money. But does this fair value represent the actual compensation cost if the realizable intrinsic value may be a different amount, even zero? The answer is yes: the grant-date fair value is a reasonable estimate of the future expected compensation cost because it is based on option valuation methodology that estimates the future cash flow and then discounts it to the present. The estimate of an option’s fair value is similar to the estimate of the fair value of a debt security based on the simple “net present value” calculation. The option

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70. See the Internet support site for this Alert, www.kerlouet.com, for the paper that discusses this type of notation.

71. *Price discovery* is a term of art used by financial engineers. It means that the market price for an item is readily observable. The quality of price discovery depends on the nature of the market for the item, including volume and frequency of trading.

methodology arrives at a discounted present value by using both interest rate and probability-type factors (regardless of the model selected), whereas the net present value method applied to a fixed income security uses only an interest rate in the discounting process.

FASB Statement No. 123(R) applies the following remeasurement principles to ESOs. (See Section III on the detailed accounting provisions of FASB Statement No. 123(R).)

1. *If the ESO is recorded as a liability.* Subsequent to the grant date, the ESO is treated as a derivative classified as a liability; in a manner consistent with FASB Statement No. 133, the ESO is remeasured on every reporting date and changes in its fair value are recorded as compensation costs using the earnings rules that apply to the ESO contract.
2. *If the ESO is classified as equity.* Subsequent to the grant date, the ESO is treated as an equity instrument; in a manner consistent with GAAP for other equity instruments, the ESO is not remeasured, thereby preventing the recognition of earnings from an equity item.

The method easily defeats the criticisms that an ESO cannot be valued for reporting purposes. It can be used to measure the fair value of the ESO on the grant date and at any subsequent remeasurement date required under FASB Statement No. 123(R). The audit approach locates proxies for the ESO that are traded or efficiently valued and that, with a possible adjustment factor, can act as substitutes for the ESO. These proxies can result in a reportable fair value that meets the SEC description of an exchange price.

The auditing approach to ESO valuation is based on established principles of financial economic theory, specifically the equivalency of a derivative to its replicating portfolio under no arbitrage conditions. In turn the grant-date fair value is the sum of the fair value of component instruments in the replicating portfolio. These fair values are market values of similar instruments, or mark-to-model values of similar instruments when observable

market prices are not available. When valuations are performed, the modeling techniques are applications of the fundamental propositions of corporate finance, including the time value of money and risk-neutral valuation.⁷² Finally the auditing approach to valuation is consistent with the FASB Statement of Financial Concepts No. 7 definition of *fair value*, which is designed to be a “*value in a current exchange*.”⁷³ The component values and the aggregation of an ESO fair value mirror the “amount [at which] instruments with the same characteristics . . . would be exchanged.”⁷⁴

Matching Valuation Methodology to Contract Terms and Parameter Specifications

The principle valuation difficulty with respect to ESOs is that they contain many contract terms that are relevant to valuation, but such terms are either excluded from valuations or poorly specified in newer models built for ESOs. The ESO contract terms that reappear as valuation issues include:

1. The length of the contracts.
2. The treatment of the vesting period.
3. The contract provisions for termination or alteration of the contract if employment is terminated.

Even if a model perfectly reflected the ESO contract terms, there would still be difficulty in selecting the parameter values to be used as inputs to the model to generate fair values. Since ESOs are both long dated and permit exercise at any time during a potentially lengthy exercise period, the expiration date of the ESO contract seems to consistently overstate the expected maturity of

72. For more detailed guidance, see the fair value guidelines of FASB Statement No. 123(R) incorporated in its Appendix A under the title “Fair Value of Instruments Granted in a Share-based Payment Transaction.”

73. See FASB Statement No. 123(R), paragraph A7.

74. See FASB Statement No. 123(R), paragraph A8.

the contract.⁷⁵ Option models and modern financial economic theory have many ways to estimate the volatility and associated probability factors. In the case of ESOs, the volatility estimate must suit the particular ESO issuer and must also be consistent with the terms of the ESO contract: a three-year volatility estimate on the S&P 500 would not be a likely estimate of volatility for a seven-year ESO contract on a small biotechnology company that has just gone public. The summary of SAB No. 107 includes a discussion of the issues that should be considered in specifying expected maturity and expected volatility.

Section VII: How Can Stock Option Expense Be Minimized?⁷⁶

Companies will most likely begin to seek ways of reducing their stock compensation expense, as a large percentage of the reporting entities within the FASB constituency continue to debate the provisions of FASB Statement No. 123(R). The battle against FASB Statement No. 123(R) was focused on two fronts: opposition to recognizing compensation expense and claims that the value used for expensing was not determinable for accounting purposes. Although the press has recounted that FASB Statement No. 123(R) has generally been well received, some rough surveys show the acceptance rate to be no more than 50 percent in various industry segments.

Given this history, it is not surprising to find evidence of alternative means of compensation or modified ESO contract terms designed to minimize the expense reported for stock options. The

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75. In other regulations on the market risk posed by derivatives, the SEC has recognized that any financial instrument with an imbedded put or prepayment option (with the option being held by the entity's counterpart or investor) is likely to result in an expected maturity shorter than the stated maturity. Residential mortgages are one class of assets with this prepayment risk. See the SEC Market Risk Rule in SEC FRR. 48.

76. The author and the AICPA staff do not mean to suggest or support earnings management schemes or devices that would bias fair value to a minimum or a maximum value. The reader is reminded that the goal of ESO fair value measurement is to provide a fair value in financial statements that reflects an "exchange price" (see Section III).

four general strategies that have emerged are (1) ESO contract modification, (2) substitution of other forms of compensation, (3) adjustment of the valuation parameters, and (4) the potential deferral of compensation charges.

ESO Contract Modification

If an entity wishes to minimize the expense representing ESO compensation, it can alter ESO contract terms that are captured in valuation methodologies in order to produce a favorable measurement outcome. The form of the contract modification would need to reflect some care over whether the goal is minimizing grant-date fair value or minimizing the cumulative fair values recorded over the life of the contract. In addition, many of these contract modifications can act only to reduce the entity's expense by reducing the compensation paid to the worker.

Regardless of the valuation methodology, some of the following contract changes to standard option contract provisions would reduce the contract value and the expense recognized:

1. The term of the option is shortened.
2. The vesting period of the option is lengthened.
3. The strike price is raised.
4. The exercise features are constrained in some way that makes exercise during an in-the-money period less likely.

Substitution of Other Forms of Compensation

In the early stages of the FASB Statement No. 123(R) deliberations, some proponents of stock option expensing were discovered to be using restricted stock and eliminating the ESO as a compensation tool. Even those who opposed stock option expensing on policy grounds (the need to define core earnings and eliminate manipulation of earnings before adding another expense variable to the income statement) favored the substitution of restricted stock for ESOs.

The use of restricted stock is thought to minimize the moral hazard opportunities represented by ESOs. As a leveraged option derivative, ESOs escaped easy detection and measurement; the accounting standards before FASB Statement No. 123(R), which were more disclosure-based, were criticized for the poor way in which they reported the dilution risk of ESOs. The award of restricted stock, however, attacks the problem of dilution risk by actually issuing shares. Investors are more able to encourage control of unwanted dilution when they see issuances of additional shares. Also, employees are more likely to have an incentive attachment to the entity when they own shares that may be lost, rather than have a choice but not an obligation to purchase shares sometime in the future, as in the case of ESOs.

However, the substitution of restricted stock for ESOs comes at a price. The incentive arrangement between the entity-employer and the stockholder-employee does not duplicate the contractual relationship of the ESO, and the dilution risk becomes realized at an early stage of the compensation arrangement.

Adjustment of the Valuation Parameters

The structure of most fair-value models used in the ESO valuation process calls for estimating relatively sophisticated financial variables. These variables are estimated from more basic capital market variables. Capital market estimates of volatility ranging from implied volatility to historical volatility may appear in the form of “expected volatility.” The probability that the ESO will be exercised before its expiration date is reflected in an estimate of the “expected maturity” of the contract. Aside from the “no exercise” feature during the vesting period, exercise features may be limited by other specific contract terms, including forfeiture and nontransferability.

The value of any option can be minimized by any one of the following means:

1. Reducing the estimate of volatility.
2. Shortening its term.

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3. Interpreting the contract to contain a legal exercise limitation.

The Potential Deferral of Compensation Charges

FASB Statement No. 123(R) includes guidance for amortizing the cost of the ESO over the life of the vesting period, as described in the previous sections. In addition, SAB No. 107 states that some ESO costs may be capitalized as inventory, as such ESO costs may be deemed to be a labor cost related to inventory. The compensation expense related to the ESOs would subsequently be recognized as cost of sales once the inventory is sold.

Section VIII: Regulatory Actions Affecting FASB Statement No. 123(R) Since Issuance

After the issuance of FASB Statement No. 123(R) in December 2004, the SEC and the FASB acted promptly to issue additional guidance and clarification on topics such as the effective date of the accounting standard, guidelines for measuring the fair value of the instruments recognized in the financial statements, and other issues that the constituents of the accounting rulemaking process have put to these regulators. The additional guidance began with the issuance of SEC SAB No. 107 and continues with the issuance of FASB staff positions on specific implementation topics. The following sections summarize the key provisions of the items that the SEC and FASB have issued since December 2004.

Statements of the SEC Chief Accountant

The SEC Chief Accountant has been very active in the implementation of FASB Statement No. 123(R). On the date FASB Statement No. 123(R) was issued, the SEC Chief Accountant noted that the standard resulted in the principal regulatory goal of providing “more comparable information in financial statements.”⁷⁷

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77. See SEC Chief Accountant Statement on FASB Statement No. 123(R), December 16, 2004.

In this statement he encouraged financial statement preparers and their auditors to “use their best judgment” concerning the difficult tasks of “[using] assumptions and estimates...and some of the inputs to valuation models” and noted that the SEC staff was preparing to provide appropriate implementation guidance.

On March 29, 2005, the Chief Accountant announced the release of SAB No. 107, which among other things “provides the staff’s views regarding the valuation of [ESOs].”⁷⁸ This announcement reiterates the general understanding that the issuance of FASB Statement No. 123(R) had been “controversial... [and the result of FASB deliberations and discussions that were] extensive and far-reaching.” As forecasted in FASB Statement No. 123(R) and SAB No. 107, the hoped-for improvement in FASB Statement No. 123(R) should be an ongoing process in which the SEC “will continue to monitor [FASB Statement No. 123(R)] implementation . . . and . . . consider the need for additional guidance as necessary.” That additional guidance has been issued through subsequent announcements of the SEC and further implementation guidance and accounting rules issued by the FASB described below. SAB No. 107 is described in Section V of this Alert.

On April 14, 2005, the SEC Chief Accountant announced a postponement of the required effective date of FASB Statement No. 123(R) to the beginning of the next fiscal year after June 15, 2005, which for most public SEC reporting companies with calendar year ends means that the statement can be implemented as of January 1, 2006. The SEC noted that the additional implementation time, among other things, would allow companies to “change their accounting systems in a more orderly fashion and should allow auditors to conduct more consistent audit and review procedures.”⁷⁹

78. See SEC Office of the Chief Accountant and Division of Corporation Finance Release Staff Accounting Bulletin, March 29, 2005.

79. See “Commission Amends Compliance Dates for FAS123(R) on Employee Stock Options,” issued April 14, 2005.

Statement of the SEC Chairman

On September 9, 2005, the SEC Chairman announced the release of informal SEC staff progress reports on the “evaluation of proposals to value employee stock options for financial reporting purposes.”⁸⁰ When FASB Statement No. 123(R) was issued, the FASB noted that in its early implementation fair values might need to be estimated from “mark-to-model” procedures as employee stock options and similar instruments were not traded; the FASB also expressed the hope that eventually, traded markets in such instruments would emerge, and that the resulting market prices would represent an improvement in fair values used for financial reporting purposes. One SEC issuer had worked for some months to create a traded instrument whose values could be used as a proxy or an indirect indicator of the fair value of ESOs that the company issued to employees. As part of this innovation, the issuer sought the assurances of the SEC that the proxy market prices would be suitable, and possibly the best estimate, of ESO fair values. It is widely understood that SEC Chairman Cox’s announcement was the strongest statement that the SEC was willing to make on the proposed innovation; the SEC’s announcement did not mention the issuer directly.

SEC Chairman Announcement

The SEC Chairman encouraged continued market innovation, which he saw as “robust efforts . . . that have the potential to accurately measure the cost of [ESOs, although the current SEC views are] subject to ongoing assessment.” He emphasized the current position of the SEC and the FASB that when available, current market prices, for example, those derived from “the use of an appropriate market instrument . . . [have] distinct advantages over a [mark-to-model] approach.” The SEC announcement included separate announcements by the SEC Chief Accountant and the release of reports on the topic of ESO valuation by the SEC’s Office of Economic Analysis.

80. See SEC Press Release 2005-129 of September 9, 2005, “Statement of Chairman Christopher Cox regarding use of Market Instruments in Valuing Employee Stock Options”, available at www.sec.gov/news/press/2005-129.htm.

Statement by the SEC Chief Accountant

Simultaneously with the SEC Chairman's announcement, the SEC Chief Accountant issued a statement concerning the SEC staff's assessment of "several different strategies being considered by issuers in an attempt to bring market forces to bear on the valuation of employee stock options."⁸¹ He notes that while the "measurement objective [of FASB Statement No. 123(R)] is to estimate the grant-date fair value of the [ESOs], . . . the FASB did not attempt to consider the appropriate design of an instrument that might [proxy for the ESOs in order to derive] a market-based value of [ESOs]." The SEC Chief Accountant stated that he and the SEC staff were now "comfortable that it should be possible to design [such proxy] instruments . . . and further . . . [the SEC had] significant doubts based on [Office of Economic Analysis]'s views, as to whether it would be possible to design [such a proxy] . . . instrument . . . by relying on similar contractual terms and conditions [of an actual ESO contract]." While this speech could not address the specific discussion brought before the SEC Chief Accountant by an identified SEC issuer, he encouraged "continuing . . . research on methods to obtain estimates of fair value for [ESOs]." Thus, as of November 30, 2005, absent other regulatory findings, mark-to-model approaches to estimate the fair value of ESOs continue to appear to be more efficient ways to meet the measurement objectives of FASB Statement No. 123(R) than market-based approaches.

Memorandum Issued by the SEC Office of Economic Analysis

The SEC Chief Accountant's statement of September 9, 2005, references an August 31, 2005, Memorandum issued by members of the SEC Office of Economic Analysis on the topic of the use of proxy instruments to derive a FASB Statement No. 123(R) fair

81. See "Speech by SEC Staff: Statement Regarding Use of Market Instruments in Valuing Employee Stock Options," by Donald T. Nicolaisen, Chief Accountant, U.S. Securities and Exchange Commission, September 9, 2005, available at www.sec.gov/news/speech/spch090905dtn.htm.

value for ESOs.⁸² The memorandum describes “[a] market-based approach [as involving a proxy] instrument that will be traded among willing buyers and sellers, and the use of the instrument’s market price as a reasonable estimate of the grant-date fair value of the [ESOs].” The summary of the economic analysis is that attempts at replicating the contractual terms of the ESOs fail to produce a reasonable estimate of fair value for purposes of FASB Statement No. 123(R) but that approaches that “track the future flows of *net obligations* facing the company or *net receipts* . . . can yield reasonable estimates of fair value as defined in [FASB Statement No. 123(R)].” Of interest is that the SEC’s SAB No. 107 prompted many approaches with various instruments designed for market trading in the hopes of allowing the derivative of a FASB Statement No. 123(R) fair value; thus while SAB No. 107 prompted valuable market research and potential innovation, further work is anticipated to map those market innovations into sound accounting policy and compliance. The memorandum then addresses two approaches within the question of *instrument design*: the “tracking” approach, and the “terms and conditions” approach.

In the tracking approach, one attempts to create an instrument whose cash payouts “are identical to the [net cash flows under the ESO contract].” Such traded instruments would not face the restrictions common to ESO contracts on trading or hedging. Without these restrictions, the SEC holds out the possibility that the resulting market price would be a “reasonable estimate of fair value.”

In the terms and conditions approach, the traded contract replicates all the terms and conditions of an ESO contract, including the restrictions mentioned above. The SEC’s current belief is that there are inherent difficulties with such an instrument that will likely prevent its market price from being a reasonable estimate of fair value.

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82. See the SEC Office of Economic Analysis Memorandum, “Economic Evaluation of Alternative Market Instrument Designs: Toward a Market-based Approach to Estimating the Fair Value of Employee Stock Options”, August 31, 2005, available at www.sec.gov/news/extra/memo083105.htm.

In a previous memorandum, the SEC Office of Economic Analysis had characterized the valuation methods cited in FASB Statement No. 123(R), notably the Black-Scholes-Merton and Binomial option pricing models, as “conventional and well-known.”⁸³ This memorandum, which prepared the ground for the issuance of SAB No. 107, summarizes the rationale for the accounting policy required by FASB Statement No. 123(R) (the expensing of ESOs), the historical reliance of the FASB and the SEC on the identified pricing models for purposes of ESO valuation, and the SEC’s economic perspective on the difficulty SEC issuers face in obtaining “reliable parameters and inputs . . . for estimating the value” of ESOs by the identified standard methods. The body of that memorandum represents an incentive for all auditors to rely on the detailed valuation guidance the FASB and the SEC have already issued on the estimation of ESO fair value in the body of FASB Statement No. 123(R) and SAB No. 107 and their precursors in the regulatory literature, notably, FASB Statement No. 123.

FASB Actions: FASB Statement No. 123(R) FSPs, FASB Statement No. 133 Revisions, and New Standards

The FASB has continued to improve accounting guidance on financial instruments by issuing specific implementation guidance for FASB Statement No. 123(R). The DIG has taken action on FASB Statement No. 133 that may affect FASB Statement No. 123(R) implementation and the new proposed accounting standard, “Fair Value Measurement.”

New FASB Statement No. 123(R) Implementation Guidance From FASB Staff Positions

The FASB has posted three relevant FASB Staff Positions (FSPs) and one proposed FSP to its Web site since August 2005.

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83. See the Office of Economic Analysis Memorandum, “Economic Perspective on Employee Option Expensing: Valuation and Implementation of FAS123(R),” March 18, 2005, available at www.sec.gov or www.kerlouet.com.

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1. FSP FAS123(R)-1. This staff position is on the topic of balance sheet recognition and measurement of financial instruments representing share-based payments under FASB Statement No. 123(R) whose holder ceases to be an employee of the issuer of the freestanding instrument. It was posted to the FASB Web site on August 31, 2005. If the freestanding instrument was subject to FASB Statement No. 123(R) when issued to the holder, the issuer should continue to recognize and measure that instrument under FASB Statement No. 123(R), unless the instrument is modified after the holder ceases employment; in the case of such modification, “recognition and measurement of the instrument should be determined [by] . . . other applicable GAAP.”⁸⁴ The financial statement preparer is expected to implement this guidance effective with its adoption of FASB Statement No. 123(R) using one of two methods described in paragraph 7 of the FSP.

 2. FSP FAS123(R)-2. This staff position is on the topic of the grant-date share-based payments being subject to FASB Statement No. 123(R) on the date they are granted, but the determination of that date can be difficult. It was posted to the FASB Web site on October 18, 2005. The grant date is the date when “mutual understanding of the key terms and conditions of [the share-based payment to an employee] shall be presumed to exist...if...the award is a unilateral grant [which will not be further negotiated] . . . and [notice of the award to the employee can be expected] within a relatively short time period from the date [the award is approved under the issuer’s relevant rules of corporate governance].”⁸⁵ The financial statement preparer is expected to implement this guidance effective with the adoption of FASB Statement No. 123(R) or, if that date preceded the posting of the FSP on the FASB Web site, the first reporting period for which financial statements are prepared after the FASB Web site posting date.

84. FSP FASB Statement No. 123(R)-1, paragraph 6.

85. FSP FASB Statement No. 123(R)-2, paragraph 5.

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3. FSP FAS123(R)-3. This staff position is on the topic of “accounting for the tax effects of share-based payment awards [subject to FASB Statement No. 123(R)].”⁸⁶ It was posted to the FASB Web site on November 10, 2005. The FSP details the method described in paragraphs 68 and 81 of FASB Statement No. 123(R) for allocating amounts representing tax benefits to the additional paid-in capital account of the financial statement preparer and provides an alternative transition method of financial statement recognition, together with examples. The financial statement preparer is expected to implement the transition guidance in paragraph 81 until such time as it elects to implement the modified guidance permitted under FSP FASB Statement No. 123(R)-3; the election to use the modified guidance is a one-time election that must be taken not later than one year from the initial adoption of FASB Statement No. 123(R).

 4. Proposed FSP FAS123(R)-d. The FASB staff is proposing a new FSP on the topic of the balance sheet classification as liability or equity of certain ESOs. At the date of the publication of this Financial Reporting Alert, the topic had been posted on the FASB Web site (www.fasb.org) and remained open for comment through January 31, 2006. The proposed guidance would amend paragraphs 32 and A229 of FASB Statement No. 123(R) concerning ESOs that “allow for cash settlement upon occurrence of a contingent event” and addresses two issues: (1) the stipulation of “the probability of the contingent cash settlement event occurring” and (2) an alternative “grandfathering [of] existing” ESOs. The final form of the FSP would be applied upon initial adoption of FASB Statement No. 123(R) with an effective date stated upon posting of the final FSP on the FASB Web site, which is expected to occur some time after January 31, 2006. A link to the final FSP will be available

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86. FSP FASB Statement No.123 (R)-3, paragraph 4.

to readers of this Financial Reporting Alert on www.kerlouet.org (see Stock Options tab).⁸⁷

New Implementation Guidance on FASB Statement No. 133 Derivatives

There has been a significant change in guidance on how to implement the fair value provisions of FASB Statement No. 133 with respect to certain derivative instruments. Share-based payments that take the form of equity-linked derivatives are subject to the fair value guidance provided in FASB Statement No. 123(R). However, as the FASB proceeds to issue a standard on fair value measurement, the additional implementation on fair value for derivatives in the case of FASB Statement No. 133 is relevant. This new FASB Statement No. 133 guidance is consistent with the guidance on fair value provided by the SEC as previously described, and the guidance that is expected to be part of the fair value guidance within the new accounting standard is expected shortly.

On December 17, 2004, the FASB DIG posted a revision to FASB Statement No. 133 Implementation Issue No. C3 to the FASB Web site (DIG No. C3⁸⁸). DIG No. C3 was originally issued on February 17, 1999, and this revision was cleared on December 15, 2004, in coordination with the FASB's issuance of FASB Statement No. 123(R). DIG No. C3 addresses which accounting rules apply to contracts such as ESOs after the employee ceases to be an employee of the ESO issuer. In such a circumstance, FASB Statement No. 123(R) would cease to apply, but the equity-linked derivative would then be subject to the provisions of FASB Statement No. 133. In addition, contracts that take the form of ESOs but are granted to nonemployees are subject to the accounting rules of FASB Statement No. 133, not FASB Statement No. 123(R), although certain scope exceptions within FASB Statement No. 133 may continue to apply.

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87. The Final FSP was posted on the FASB Web site after the date this Alert was finalized. A summary of the final FSP is available at the Internet support Web site for the Alert.

88. See FASB Statement No. 133 Implementation Issue No. C3, "Scope Exceptions: Exception related to Share-Based Payment Arrangements", posted on the FASB Web site at www.fasb.org.

New Fair Value Measurement Guidance Expected

The FASB is planning to issue a new accounting standard tentatively titled *Fair Value Measurements*. The standard is expected to “define fair value [and establish] a framework for measuring fair value.” It is understood to address the problem of “different definitions of fair value and limited guidance for applying those definitions within GAAP.”⁸⁹

The accounting standard is expected to define *fair value* as the price that would be received for an asset or paid to transfer a liability in a current transaction between marketplace participants in the reference market for the asset or liability. In the absence of a transaction involving the entity, the estimate of fair value is determined by reference to a hypothetical transaction for the asset or liability at the measurement date (the effective valuation date).

This is understood to be consistent with the guidance on fair value contained in FASB Statement No. 123(R) and the additional guidance provided by the SEC. In particular, while the estimate of fair value from actual market prices is preferred, in the case of ESOs and under the current valuation conditions examined in the most recent memorandum issued by the SEC Office of Economic Analysis, a mark-to-model approach with special attention to the selection of model inputs and parameters is expected to require the continued best judgment of financial statement preparers and their auditors.

Additional Disclosures Proposed by the SEC

The Securities and Exchange Commission acted on January 17, 2006 to promulgate additional disclosures about executive compensation that would rely upon and emphasize the need for FASB Statement No. 123(R) information. (See SEC Press Release 2006-10, available at www.sec.gov/news/press/2006-10.htm.) The proposed rule is intended to require new narrative disclosure to “elicit clear and more complete disclosures on the compensation of the [entity’s] principal executive officer, principal financial

89. See progress reports on the planned release of FASB Statement of Financial Accounting Standards No. 15X, *Fair Value Measurements*, at www.fasb.org.

officer, [and] the three other highest paid executive officers and directors.” As proposed, the rule will require a new narrative section on compensation that will include a reorganized “Summary Compensation Table.” Among other things, this table would include “[a] dollar value will be shown for all stock-based awards, including stock and stock options, measured at grant date fair value, computed pursuant to Financial Accounting Standards Board’s Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, to provide a more complete picture of compensation and facilitate reporting total compensation.” A full copy of the SEC press release is available at the SEC Web site (www.sec.gov) and the Web site supporting this Financial Reporting Alert (www.kerlouet.org); the latter will be updated from time to time for new portions of the proposed SEC disclosure rule that must interact with FASB Statement No. 123(R).

Summary

Fair value accounting for ESOs has been the matter of much heated debate over the past few years. FASB Statement No. 123(R) is the FASB’s attempt to bring an end to such debate and brings consistency to voluntary expensing and valuation practices that were permitted before its effective date. The FASB recognizes that valuation methodology for ESOs is a relatively young branch of financial economic theory; therefore, both FASB Statement No. 123(R) and SAB No. 107 emphasize the need to tailor generic option-pricing models to the intricate and detailed contract terms of the ESOs. Users of FASB Statement No. 123(R) must be prepared to acquire the requisite knowledge to evaluate their ESO contracts, obtain a reliable and verifiable fair value, and prepare the required accounting and disclosure entries.

APPENDIX A

Summary of the FASB Project on Financial Instruments

Key Milestones in the FASB's Financial Instruments Project Leading to FASB Statement No. 123(R), *Share-Based Payment*¹

<i>Statement of Standards</i>	<i>Issued (Amended)</i>	<i>Title</i>	<i>Key Developments Within the FASB Financial Instruments Project for ESO Accounting</i>
AICPA Issues Paper 86-2	March 1986	<i>Accounting for Options</i>	<ol style="list-style-type: none"> 1. Demonstrates common features of all option and related fair value attributes. 2. Documents for options "Fair value = Time value + Intrinsic value."
FASB Statement No. 105	March 1990	<i>Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk</i>	<ol style="list-style-type: none"> 1. Requires disclosure of the notional amounts of financial instruments in the notes to financial statements (as part of disclosures about financial instruments with off-balance-sheet risk of accounting loss).
FASB Statement No. 107	December 1991	<i>Disclosures about Fair Value of Financial Instruments</i>	<ol style="list-style-type: none"> 1. Requires disclosure of fair value for financial instruments, both on- and off-balance-sheet. 2. Extends the use of fair value as the relevant measure.
FASB Statement No. 115	May 1993	<i>Accounting for Certain Investments in Debt and Equity Securities</i>	<ol style="list-style-type: none"> 1. Extends the use of fair value as the measurement principle to all asset classes for securities within the scope except for "held-to-maturity securities." 2. Provides income recognition rules for fair value changes (charge to earnings or OCI²).

(continued)

<i>Statement of Standards</i>	<i>Issued (Amended)</i>	<i>Title</i>	<i>Key Developments Within the FASB Financial Instruments Project for ESO Accounting</i>
FASB Statement No. 119	October 1994	<i>Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments</i>	<ol style="list-style-type: none"> 1. Excludes ESOs from scope. 2. Extends the fair value disclosure requirements for financial instruments to include derivatives.
FASB Statement No. 123	October 1995	<i>Accounting for Stock-Based Compensation</i>	<ol style="list-style-type: none"> 1. Defines but does not require a <i>fair value-based method</i> for ESOs. 2. Permits the use of the <i>intrinsic value method</i> with required pro forma disclosures of income using the fair value method. Result: ESOs remain “off balance sheet.”
FASB Statement No. 128	February 1997	<i>Earnings per Share</i>	<ol style="list-style-type: none"> 1. Specifies methods for computing EPS for both common stock and potential common stock. 2. Relates treasury stock method to ESOs.
FASB Statement No. 133	June 1998 (1999, 2000, and 2001)	<i>Accounting for Derivative Instruments and Hedging Activities</i>	<ol style="list-style-type: none"> 1. Excludes ESOs from scope. 2. Reaffirms fair value as the measurement principle for derivatives. Result: Derivatives are recognized on-balance-sheet.
FASB Statement No. 123R	December 2004	<i>Share-Based Payment</i>	Requires mandatory ESO expensing at grant-date fair value.

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1. Copyright © 2005 Louis P. Le Guyader. All rights reserved. This exhibit is an update of an exhibit presented by the author during his dissertation defense at Columbia University in 1998. *Used by permission.*
 2. The FASB Concepts Statements define *comprehensive income* as the sum of earnings and “other comprehensive income (OCI).” OCI rules can be found in FASB Statement No. 130, *Reporting Comprehensive Income*.

FASB Statement No. 123(R) represents the FASB’s most recent progression to recognize all derivatives on the balance sheet using fair value as the measure. Much of the fair value measurement, recognition, and disclosure principles had been developed for derivatives and financial instruments other than ESOs.

APPENDIX B

***Summary of Examples and Illustrations
Contained in FASB Statement No. 123(R)***

FASB

Statement No.

123(R) Paragraph

FASB Statement No. 123(R) Classification

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(continued)

*FASB**Statement No.**123(R) Paragraph**FASB Statement No. 123(R) Classification*

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<i>FASB Statement No. 123(R) Paragraph</i>	<i>FASB Statement No. 123(R) Classification</i>
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APPENDIX C

Other Resources for Readers

The accounting guidance for implementers of FASB Statement of Financial Accounting No. 123(R), *Share-Based Payment*, as of January 31, 2006, includes the following documents, which can be accessed through the Web site www.kerlouet.com unless otherwise noted:

1. Precursors to FASB Statement No. 123(R) available at www.fasb.org:
 - a. Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees*
 - b. FASB Statement No. 123, *Accounting for Stock-Based Compensation*
 - c. FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123*
2. Other FASB Documents available at www.fasb.org
 - a. FASB Statement No. 123(R)
 - b. FASB Statement No. 123(R): Questions and Answers as of December 16, 2004
 - c. FASB Staff Interpretations of FASB Statement No. 123(R)
3. SEC Documents available at www.sec.gov
 - a. SEC Staff Accounting Bulletin No. 107, *Share-Based Payment*
 - b. Announcements, Press Releases and other documents from the SEC Commission, the SEC Chairman, the SEC Chief Accountant and the SEC Office of Economic Analysis

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4. Related FASB Actions (related documents are available at www.fasb.org)
 - a. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, guidance on fair value measurement for certain non-ESO derivatives
 - b. FASB plan to issue accounting standard, Fair Value Measurement
 - c. FASB and International Accounting Standards Board Fair Value Option (or Free Choice) Project

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