FINANCIAL ACCOUNTING STANDARDS BOARD

STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123 (REVISED 2004), *SHARE-BASED PAYMENT*

FREQUENTLY ASKED QUESTIONS

DECEMBER 16, 2004

This document was prepared to respond to questions related to the Board's decisions on accounting for share-based payment transactions as presented in the Statement referenced above. Following the Frequently Asked Questions is a summary description of the Statement's provisions.

This material is presented for discussion purposes only. Official positions of the FASB are determined only after extensive due process and deliberations.

For a comprehensive discussion of the issues associated with the accounting for share-based payment transactions, refer to FASB Statement No. 123 (revised 2004), Share-Based Payment, *which is available on the FASB website at www.fasb.org.*

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FREQUENTLY ASKED QUESTIONS

Q1. What is a share-based payment?

A share-based payment is an arrangement under which (1) one or more suppliers of goods or services (including employees) receive awards of equity shares, equity share options, or other equity instruments or (2) the entity incurs liabilities to suppliers (1) in amounts based, at least in part, on the price of the entity's shares or other equity instruments or (2) that requires or may require settlement by issuance of the entity's shares.

Q2. What is a share option?

A share option is a contract that gives the holder the right, but not the obligation, to purchase (or sometimes sell) a certain number of shares at a predetermined price (usually referred to as a *strike price*) for a specified period of time. The holder of the share option pays to obtain that right (usually referred to as the *option premium*). For exchange-traded options, that premium payment is usually made in cash. For example, an investor might pay $5 (the premium) for the right to purchase 100 shares of stock for $10 per share (the strike price) at any time over the next 3 years.

Share options also are granted to employees as compensation for their services. For example, an employer might give an employee a share option that gives the employee the right to purchase 100 shares of the employer's stock at $5 per share for up to 10 years. That type of share option is often referred to as an *employee share option*. For those options, the premium payment is made in the form of employee services, rather than cash. The predetermined price ($5 per share in the example) is often referred to as the option's *exercise price* (or *strike price*).

Q3. Why does an employee share option have value?

An employee share option has value because it gives the employee the right to benefit from increases in the share price over the exercise price during the option's contractual term. Continuing with the example in Q2, suppose the employer's share price increases to $20 per share. The employee exercises the options by paying the strike price, $500 in total (100 shares × $5 per share), to the employer and in exchange receives 100 shares valued at $2,000 (100 shares × $20 per share). Therefore, the employee obtains an economic benefit of $1,500 ($2,000 – $500) from exercising the options. The opportunity to receive a potential gain if the price of the employer's shares increases over the option's exercise price during the option's contractual term is the basis for the option's initial value.

While very different in nature and purpose, the potential gain that makes an employee share option valuable is similar to the potential gain that makes a lottery ticket valuable. An individual buys a lottery ticket because it gives the holder the right to potentially receive valuable assets (generally cash) in the future. The payment for the lottery ticket is similar to the option premium paid (cash or employee services) for the share option. Even if the probability of winning those valuable assets is extremely low, the lottery ticket still has value until the winning number is known (at which point the winning ticket's value increases, and a losing ticket's value decreases to zero). In contrast to a typical lottery ticket, which is valid for one drawing only, a share option is valid for multiple drawings (that is, each day a share option is outstanding can be viewed as an independent drawing because the value of the share can change, making the share option more or less valuable).

Just as millions of lottery tickets are purchased each year, millions of share options are bought and sold each year in the United States on organized option exchanges, the largest of which is the Chicago Board Options Exchange (CBOE). The CBOE reported that nearly 270 million contracts were traded during its 2003 fiscal year; 159.3 million of those contracts related to options on equity securities.[1] Investors pay significant amounts to obtain rights to potentially benefit from future increases (or decreases) in the price of individual equity securities and equity security indexes. While exchange-traded share options are different from employee share options (refer to Q11), both types of options have value for the same reason.

Q4. Why did the FASB add a share-based payment project to its agenda?

As originally issued in 1995, FASB Statement No. 123, *Accounting for Stock-Based Compensation*, established the fair-value-based method of accounting as preferable for share-based compensation awarded to employees and encouraged, but did not require, entities to adopt it. At that time, the Board believed that financial statements would be more relevant and representationally faithful if the estimated fair value of employee share options was included in determining an entity's net income. The Board also believed that financial reporting would be improved if all equity instruments granted to employees, including instruments with variable features such as options with performance criteria for vesting, were accounted for on a consistent basis.

Statement 123 allowed entities to continue accounting for share-based compensation arrangements with employees according to the intrinsic value method in APB Opinion No. 25, *Accounting for Stock Issued to Employees*, under which no compensation cost was recognized for

[1]Chicago Board Options Exchange, Annual Report 2003 (www.cboe.com).

employee share options that met specified criteria. Public entities that continued to use the intrinsic value method were required to disclose pro forma measures of net income and earnings per share as if they had used the fair-value-based method. Nonpublic entities that continued to use the intrinsic value method also were required to make pro forma disclosures related to net income, but could use either the minimum value method[2] or the fair-value-based method in arriving at the disclosures. The Board's decision at that time was based on practical rather than conceptual considerations.

Concerns of Users of Financial Statements

Before 2002, virtually all entities chose to continue to apply the provisions of Opinion 25 rather than to adopt the fair-value-based method to account for share-based compensation arrangements with employees. The financial reporting failures that came to light beginning in 2001 led to a keen interest in accounting and financial reporting issues on the part of investors, regulators, members of the U.S. Congress, and the media. Many of the Board's constituents who use financial information said that the failure to recognize compensation cost for most employee share options had obscured important aspects of reported performance and impaired the transparency of financial statements.

The increased focus on high-quality, transparent financial reporting created a growing demand for entities to recognize compensation cost for employee share options and similar instruments—a demand to which entities began to respond. As of March 2003, when the Board added this project to its agenda, 179 public companies had adopted or announced their intention to adopt the fair-value-based accounting method in Statement 123. By May 2003, that number had grown to 276 public companies, of which 93 were companies included in the Standard & Poor's (S&P) 500 Index; those companies represented 36 percent of the index based on market capitalization. By July 2004, that number had increased to 753 public companies.[3]

Improving Comparability

Although a number of entities have voluntarily adopted the fair-value-based accounting method in Statement 123, it did not appear likely that voluntary adoption would extend to all entities, at least not in the foreseeable future. Voluntary adoption of Statement 123's fair-value-based accounting method by increasing numbers of entities provided improved information about the effects of share-based payment arrangements with employees on those entities and their

[2]Minimum value is an amount attributed to an option that is calculated without considering the expected volatility of the underlying stock.

[3]Refer to Pat McConnell, Janet Pegg, Chris Senyek, and Dane Mott, "Companies That Currently Expense or Intend to Expense Stock Options Using the Fair Value Method," Bear Stearns (May 23, 2003), and Bear Stearns update (July 20, 2004).

shareholders. However, that voluntary adoption also resulted in less comparability across entities because of the alternative accounting methods Statement 123 continued to permit.

Simplifying U.S. GAAP

The existence of alternative accounting methods for share-based compensation arrangements with employees, coupled with the failure of Opinion 25 to provide much general guidance on applying its intrinsic value method, had resulted in voluminous accounting guidance that constituents said was disjointed, rule-based, and form-driven.[4] Both the Board and the Emerging Issues Task Force (EITF) had responded to requests for guidance on a large number of implementation issues. For example, FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*, addressed 20 implementation questions, many of which had 1 or more subquestions. The EITF addressed an additional 51 implementation issues in EITF Issue No. 00-23, "Issues Related to the Accounting for Stock Compensation under Opinion No. 25 and FASB Interpretation No. 44." Constituents asked the Board to simplify the existing accounting guidance on accounting for share-based payment arrangements by eliminating the alternative of using Opinion 25's intrinsic value accounting method.

International Convergence

In November 2002, the International Accounting Standards Board (IASB) issued an Exposure Draft, *Share-based Payment* (ED2), that proposed a single, fair-value-based method to be used to account for all share-based compensation arrangements. Although the method that the IASB proposed in ED2 shared some important features of the fair-value-based method in Statement 123, it also differed in certain significant respects. In November 2002, shortly after the IASB issued ED2, the FASB issued an Invitation to Comment, *Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123,* Accounting for Stock-Based Compensation, *and Its Related Interpretations, and IASB Proposed IFRS,* Share-based Payment. The Invitation to Comment explained both those similarities and differences. Most users of financial statements who responded to the Invitation to Comment urged the Board to undertake a project to require that entities account for share-based payment arrangements with employees using a fair-value-based method. The majority of the preparers who responded did not support such a requirement. However, some of those preparers asked for additional guidance on applying the fair-value-based method in Statement 123.

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

To take advantage of the opportunity for international convergence, the FASB concluded that it needed to reconsider the U.S. accounting requirements for share-based payment arrangements concurrently with the IASB's consideration of responses to ED2.[5]

Q5. What share-based payment instruments are included in the scope of the Statement?

The Statement establishes standards for the accounting for share-based payment arrangements as described in Q1. There has been a long practice of recognizing expense in the financial statements for many share-based payment arrangements. The most significant change that the Statement brings about is requiring expense recognition for certain types of employee share options; however, the Statement's scope includes other share-based payment arrangements, including restricted shares, share appreciation rights, employee share purchase plans, and share options with performance conditions. The requirements of the Statement result in greater consistency in the accounting for various forms of equity-based payment arrangements. The Statement does not change the accounting guidance for share-based payment transactions with parties other than employees provided in EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services." The Statement does not address the accounting for employee share ownership plans currently accounted for under AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans*.

Q6. How did the Board solicit and consider the views of constituents?

The share-based payment project was subject to the Board's usual extensive and open due process. That process began with the Invitation to Comment issued in November 2002. That Invitation to Comment compared the IASB's proposed standard on accounting for share-based payment with the requirements in the FASB's Statement 123 and solicited constituent comments on those differences. Most users of financial statements that commented on the Invitation to Comment urged the Board to add a project to reconsider Statement 123 to its agenda, and the Board did so in March 2003.

Deliberation of the technical issues began in April 2003 and culminated with the issuance of an Exposure Draft in March 2004. The Invitation to Comment and Exposure Draft documents were significant parts of the process of obtaining input and views from constituents. During the course of its deliberations, the Board met with many constituent groups, as well as the Options

[5]The IASB issued IFRS 2, *Share-based Payment,* in February 2004.

Valuation Group that the Board organized to support the share-based payment project. That group includes valuation experts from the compensation consulting, risk management, investment banking, and academic communities. Immediately prior to the Board's redeliberations, which began after the Exposure Draft's 90-day comment period ended and the comments on the Exposure Draft were analyzed, the Board held 4 public roundtable meetings and met with other constituents, including the Board's User Advisory Council and Small Business Advisory Committee, as well as other liaison groups. After analyzing input received, the Board decided to modify some of its previous decisions and incorporate suggested changes into the final Statement.

Q7. Why wasn't the proposed Statement *field tested* and how did the FASB assess the cost-benefit considerations?

The Board uses the term *field test* to describe a formal application of a proposed Statement by a group of entities to their particular circumstances. The participating entities are provided with a description of the proposed approach (if an Exposure Draft has not yet been issued) and are asked to apply that approach either to current transactions or retroactively to one or more prior years. A field test may involve having the participating entities prepare financial statements in accordance with a proposed approach to accounting for a particular type of transaction.

The Board uses the term *field visit* to describe meetings with companies or firms to discuss a possible change in the way a transaction, such as a share-based payment transaction, is accounted for. A field visit may involve Board and staff members meeting with individual entities at their offices (or sometimes by means of a conference call) to engage in an in-depth discussion of a proposed Statement. Entities participating in a field visit program usually are provided with a draft of the proposed requirement, together with a list of discussion questions. The questions focus on helping the Board and staff to better understand the costs and benefits of changing to the proposed approach, the operationality of the proposed approach, and any barriers the entity would face in applying it.

The Board concluded that field visits were an appropriate means of gathering information about the perceived costs of the proposed changes to the fair value-based method. Field tests were conducted when it developed Statement 123. Because Statement 123(R) builds from and improves on the fair-value-based method in Statement 123, the Board decided that it should conduct field visits rather than field tests as part of the development of Statement 123(R).

The field visit program included discussions with 18 enterprises selected to achieve broad coverage of constituent enterprises based on market capitalization, software used to value employee share options, filing status (public or nonpublic), industry membership, total number of employees, total awards outstanding, and types of awards outstanding. Field visit participants included preparers of financial statements, employee benefit consultants, and auditors. Before each field visit, participants received a package of materials, including a description of the proposed changes to Statement 123, a discussion of the type of information that could be incorporated into a valuation model, and questions for participants to consider. Furthermore, thousands of public entities have had many years of experience in developing fair value estimates for their share-based payment arrangements with employees—estimates that Statement 123 required for either recognition or pro forma disclosure purposes. Moreover, many enterprises have estimated and reported (or will soon estimate and report), generally consistent with the Statement's approach, all of their employee share options as an expense in their financial statements.

After comments were received on the Exposure Draft, the Board undertook additional cost-benefit procedures for nonpublic entities. Interviews were conducted with constituents, including preparers, users, and auditors of financial statements. These constituents were selected to provide a broad coverage of concerns related to nonpublic entities. In addition, small business and nonpublic entity issues were discussed at four public roundtable meetings. The Board also discussed cost-benefit issues at a meeting of the Board's Small Business Advisory Committee and with other groups that represented the small and nonpublic business community.

Based on the findings of its cost-benefit procedures, the Board concluded that the Statement will sufficiently improve financial reporting to justify the costs it will impose. Several of the Board's decisions are intended to mitigate the incremental costs of complying with the Statement. For example, an alternative measurement method based on substituting the historical volatility of an appropriate industry sector index for expected volatility also is provided for equity options and similar instruments granted by a nonpublic entity if it is not practicable to estimate the expected volatility of its share price. In addition, a nonpublic entity is not required to estimate the fair value of its liability awards; instead, such an entity may elect to account for its liability awards based on their intrinsic value. Also, transition costs for public entities have been minimized by requiring that compensation cost for the nonvested portion of awards granted before the issuance of the Statement be based on the grant-date fair values previously estimated for recognition or pro forma disclosure purposes under Statement 123.

Q8. Did the FASB consider that the Statement might have economic consequences on some entities?

The Board understands that the accounting standards it issues may have economic consequences for some entities, but its operating precepts require it to consider issues in an even-handed manner, without intentionally attempting to encourage or to discourage specific economic actions. That does not imply that improved financial reporting should not have economic consequences; a change in accounting standards that results in financial statements that are more relevant and representationally faithful, and thus more useful for decision making, presumably would have economic consequences. For example, recognition of compensation cost based on the provisions of the Statement would result in more comparable accounting for all forms of employee compensation. As a result, any decision to reassess and perhaps modify existing share-based payment arrangements would be based on financial information that better represents the economic effects of various forms of compensation.

Some investors and others have noted the dramatic increase in the number of share options awarded to employees during recent years. The Board understands that the vast majority of share options awarded to employees are fixed plan employee share options for which enterprises that continued to use the accounting requirements of Opinion 25 recognized no compensation expense. The accounting under Opinion 25 treats most fixed plan employee share options as though they were a free good, which implies that the services received in exchange for those options are obtained without incurring a cost. But employee services received in exchange for share options are not free. Share options are valuable equity instruments for which valuable consideration is received—consideration that should be recognized regardless of whether it is in the form of cash, goods, or services from employees or other suppliers. Accounting for fixed plan employee share options as though they impose no cost on the enterprise that issues them may encourage their substitution for other forms of compensation, such as share options or other instruments with performance or market conditions that may be preferable in a particular situation.

Q9. How is the fair value of an employee share option estimated under the Statement?

The Statement specifies that the fair value of an employee share option be based on an observable market price of an option with the same or similar terms and conditions if one is available. In the United States, equity instruments identical to employee share options are currently not traded (but may be in the future); hence, there are no observable market prices. The

Statement requires that the fair value of those instruments be estimated using a valuation technique that (1) is applied in a manner consistent with the fair value measurement objective and the other requirements of the Statement, (2) is based on established principles of financial economic theory[6] and generally applied in that field, and (3) reflects all substantive characteristics of the instrument (except for those explicitly excluded by the Statement, such as vesting conditions and reload features). The affect of vesting conditions are taken into account by requiring that compensation cost be recognized only for share options or restricted shares the entity expects to vest and that actually do vest. Additional information regarding estimating the fair value of an employee share option can be found in Appendix A of the Statement.

Q10. Does the Statement prescribe a specific valuation technique to be used to estimate the fair value of employee share options?

No. The Statement permits entities to use any option-pricing model that meets the fair value objective in the Statement; however, the Board believes that lattice models, including the binomial option-pricing model, are capable of more fully reflecting certain characteristics of employee share options.

A valuation technique that meets the criteria presented in the Statement (refer to Q9) may be used to estimate the fair value of employee share options. The Board considered a number of valuation techniques, including techniques suggested by constituents. Acceptable valuation techniques include the binomial option-pricing model and the Black-Scholes-Merton option-pricing formula. Those option-pricing models are based on well-established financial economic theory; indeed, those option-pricing models are based on the same financial economic theory and generally produce the same, or very similar, option values when the same input assumptions are used. Those models are used by valuation professionals, dealers of derivative instruments, and other experts to estimate the fair values of options related to equity securities, currencies, interest rates, and commodities. The Statement is designed to encourage entities to use the valuation technique that provides a reasonable estimate of fair value based on the nature and characteristics of the equity instruments being awarded. Additional information regarding estimating the fair value of employee share options can be found in Appendix A of the Statement.

[6]Established principles of financial economic theory represent fundamental propositions that form the basis of modern corporate finance (for example, the time value of money and risk-neutral valuation).

Q11. How is an employee share option different from an exchange-traded share option?

An employee share option and an exchange-traded share option are different in a number of respects. The following table highlights the most significant differences:

Feature	**Exchange-Traded Option**	**Employee Share Option**
Consideration—the option premium paid.	Cash.	Employee services.
Transferability—the ability to sell the option to a third party.	Transferable.	Generally, the option is not transferable.
Exercisability or Vesting Conditions—contractual provisions that must be fulfilled in order to earn rights to the option.	An American-style option is immediately exercisable (no vesting conditions) because it is fully paid for when acquired.	Generally, the option is not exercisable until the option is paid for, that is, when vesting conditions are satisfied (for example, the employee remains in service for a specified period of time or satisfies a performance target).
Contractual Term—the specified period of time during which the option remains outstanding.	Typically a short contractual term, the longest of which is three years.[7]	Generally, a long contractual term with a term of 10 years being common. Generally reduced to a short period of time, normally 90 days, if the employee terminates employment.
Blackout periods—periods of time during the contractual term when the option holder is prohibited from exercising the option.	Generally, the option is not subject to blackout period restrictions.	Generally, subject to blackout period restrictions.
Hedgeability—ability to hedge any unrealized option gains.	Hedgeable.	Generally subject to hedging restrictions.

The inability to transfer or hedge employee share options results in an increase in the likelihood that an employee share option will be exercised before the end of its contractual term to capture any unrealized gain. This substantially reduces the value of an employee share option. Measuring the value of the award of share options using its expected term rather than its contractual term reflects that value reduction. Thus, the Statement requires that the value of a nontransferable (and nonhedgeable) employee share option be based on its shorter expected term rather than its longer contractual term.

[7] Long-term equity anticipation securities (LEAPS) are traded on the CBOE and expire two to three years after their initial listing on the exchange (www.cboe.com).

Q12. Aren't option-pricing models applicable only for exchange-traded options?

No. The Board and FASB staff discussed this question extensively with various option valuation experts in the course of developing Statement 123 and Statement 123(R). Those experts believe that option-pricing models can be adjusted to take into account the characteristics of employee share options that make them different from exchange-traded options. Those experts also believe that adjusted option-pricing models produce reasonable fair value estimates of employee share options. Some of the major differences between employee share options and exchange-traded options are summarized in Q11. For example, restrictions on transferability increase the likelihood that the option will be exercised earlier in its contractual term. The use of the expected term rather than the contractual term in option valuations adjusts for the employee share option's nontransferability feature. The experts the Board has discussed this issue with include valuation experts, financial economists, compensation consultants, derivatives traders, academics, and other professionals who are familiar with option-pricing models and employee share options. Based on those discussions and other research performed by the FASB staff, the Board decided that option-pricing models can be adjusted to take into account the characteristics of employee share options and that those adjusted option-pricing models produce reasonable estimates of employee share options' fair value.

Q13. Given that they do not trade in the marketplace, can the fair value of employee share options be estimated with sufficient reliability for recognition in the financial statements?

Yes, the Board believes that the fair value can be estimated with sufficient reliability. The uncertainties inherent in estimates of the fair value of employee share options are generally no more significant than the uncertainties inherent in measurements of, for example, loan loss allowances, valuation allowances for deferred tax assets, pension and other postretirement benefit obligations, and in-process research and development. For those items, as well as for many other items in accounting involving the use of estimates, entities are required to use appropriate measurement techniques, relevant data, and management judgment in the preparation of financial statements. Most parties agree that financial statement recognition of estimated amounts is preferable to the alternative—recognizing nothing—which is what Opinion 25 accounting recognized for most employee share options. Zero is not within the range of reasonable estimates of the fair value of employee share options.

Thousands of public enterprises have been estimating the grant-date fair value of employee share options, generally consistent with the approach contained in the Statement, and have been reporting those amounts in their audited financial statement footnotes for many years. Moreover, approximately 750 public companies and thousands of Canadian enterprises have estimated and reported in their financial statements the cost of all of their employee share options in a manner generally consistent with the Statement's approach. On a similar note, valuation techniques are used as a basis on which negotiated prices are derived for other complicated financial instruments that are not traded, including long-dated and complex derivatives and convertible bonds containing embedded long-dated options.

Q14. Will the FASB provide a list of valuation software providers?

No. The FASB staff held a number of conversations with software developers and software service providers about the valuation capabilities of their software during the course of developing the Statement. Many of those developers and service providers responded to an FASB survey that was specifically designed to help understand the valuation capabilities of their software and the costs associated with updating that software in order to comply with the Statement. Moreover, many of the developers and service providers noted that information provided to the FASB staff was very sensitive to their competitive position in the marketplace and therefore requested that such information be considered confidential. The Board encourages companies to perform their own research and other due diligence procedures to identify or develop software applications that will provide a reasonable and supportable fair value estimate of their share-based payment instruments.

Q15. Why does the use of restricted shares and employee share options result in an expense?

An employer grants restricted shares or share options to an employee in exchange for services to be rendered by that employee. With respect to share options, those services represent the option premium paid for the right to exercise the option. The employee services received in exchange for share options by the employer are assets, if only momentarily, because receipt of a service and its use occur simultaneously. The restricted shares or employee share options are not expensed; rather, employee services received in exchange for restricted shares or employee share options are expensed as those services are consumed in the employer's operations. A share option is the employer's obligation to deliver equity securities upon exercise of the option.

To further illustrate how granting share options results in the receipt of assets, consider the following example. Company X purchases inventory valued at $100 in exchange for share options with a 10-year contractual maturity. Shortly thereafter, Company X sells the inventory for $150, recognizes an expense (cost of goods sold) of $100 in the income statement for the sale of inventory, and receives a profit of $50. Just as the inventory is recognized as an asset upon purchase and is recognized as an expense upon sale (or consumption), employee services are recognized as an asset upon receipt and are recognized as an expense upon consumption in an enterprise's operations.

Q16. How can employee share option awards that expire worthless still result in an expense for the employer?

Employee services received as payment for a share option have value regardless of whether, ultimately, (1) the employee exercises the option and purchases shares worth more than what the employee pays for those shares or (2) the option expires worthless at the end of its contractual term. This is no different from an investor paying a premium to acquire an exchange-traded option that ultimately expires worthless.

Taking the example in Q15 one step further, suppose that the holder of Company X's share options (who received them in exchange for inventory) held them for 10 years and exercised them, netting a profit of $2,000. Does this mean the inventory purchased by Company X, which was bought and sold 10 years earlier, should be valued at $2,000 rather than $100? This would suggest that Company X, rather than netting a profit of $50, realized a loss of $1,850 when it sold the inventory 10 years earlier. It did not. The inventory (or employee services) had a value of $100 when the share options were granted. That amount was based on a bargained exchange between two independent parties. The ultimate gain when share options are settled is independent of the cost of inventory (or employee services) and is a separate transaction. Even if the option expires worthless, the inventory had value when it was acquired.

The realization of a gain from the exercise of employee share options is a separate transaction from the one that resulted in the expense recognized in the income statement, namely the receipt and consumption of employee services. Consequently, an employee share option's value upon expiration, be it $10, $50, $100, or zero, does not affect the cost of employee services received and consumed in the enterprise's operations. Employee services have value, similar to inventory that was purchased in exchange for share options.

Q17. Does expensing share options result in a double hit to earnings, once through recognition of compensation expense and once through share dilution?

Some respondents to the Invitation to Comment and the March 2004 Exposure Draft said that recognizing the cost of employee services received in exchange for employee share options would inappropriately double count the effect of granting share options. They noted that the dilutive effect of in-the-money share options is included in the denominator of diluted earnings per share. To reduce net income (the numerator) by recognizing compensation expense based on fair value would, in their view, create an inappropriate dual effect on diluted earnings per share; this argument often is referred to as "earnings per share would be hit twice."

Earnings per share is a metric—no expense (cost), revenue, or other element of financial statements is recognized by including its effect only in earnings per share. A transaction that results in an expense and that also increases the number of common shares outstanding properly affects both the numerator and the denominator of earnings per share. If an entity issues shares, share options, or share purchase warrants for cash and uses the cash received to pay employee salaries, earnings are reduced and more actual or potential common shares are outstanding. Moreover, if an entity issues common shares in exchange for a depreciable asset, both the resulting depreciation expense and the increase in common shares outstanding reduce earnings per share. If an enterprise purchases legal services in exchange for the enterprise's own shares, the receipt and consumption of the legal services (or assets) result in an expense in the income statement (which affects the numerator in the earnings-per-share calculation) and the issuance of the enterprise's own shares affects the denominator in the earnings-per-share calculation. Hence, the transaction affects both the income statement and the earnings-per-share calculation.

Recognition of the compensation cost resulting from awards of employee share options is no different from the accounting for other transactions in which use of the consideration received (cash, other tangible assets, or services) for issuing equity instruments reduces reported earnings, and the related equity instruments increase either actual or potential outstanding common shares.

Q18. If the receipt and consumption of employee services result in an expense, shouldn't the value of those services be measured rather than the value of the employee share options given in exchange for those services?

Ideally, yes, but the value of employee services rendered is almost always impossible to measure directly. For that reason, accounting for the cost of employee services is based on the value of compensation paid in exchange for them, which is presumed to be a reasonable measure of the value of the employee services received. Compensation cost resulting from employee share options is thus estimated based on the grant date fair value of the share options, which is consistent with the accounting for other forms of employee compensation.

The Statement requires that employee share options provided in exchange for employee services be measured at their fair value. Fair value is defined as the amount at which an asset could be bought or sold in a current transaction between willing parties. That definition also applies to the share-based payment instruments addressed in the Statement, including employee share options. Fair value is deemed the most relevant measure of an employee share option's value because it incorporates information about the amounts, timing, and uncertainty of potential payoffs associated with the share option.

Q19. Does the Statement require expense recognition for employee share purchase plans?

It depends. Compensation cost would be recognized unless an employee share purchase plan satisfies the conditions to be considered a noncompensatory plan, which follow:

1. The plan satisfies at least one of the following conditions:

    a. The terms of the plan are no more favorable than those available to all holders of the same class of shares.

    b. Any purchase discount from the market price does not exceed the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering. A purchase discount of 5 percent or less from the market price shall be considered to comply with this condition without further justification. A purchase discount greater than 5 percent that cannot be justified under this condition results in compensation cost for the entire amount of the discount.

2. Substantially all employees that meet limited employment qualifications may participate on an equitable basis.

3. The plan incorporates no option features, other than the following:

    a. Employees are permitted a short period of time—not exceeding 31 days—after the purchase price has been fixed to enroll in the plan.

    b. The purchase price is based solely on the market price of the shares at the date of purchase, and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid (such as those paid by payroll withholdings).

Q20. Will employee share option plans be eliminated or reduced as a result of the Statement?

The Statement is not intended to either encourage or discourage an enterprise from using share options or any other particular form of share-based compensation to compensate employees; the FASB's intent is solely to establish the most appropriate accounting for various forms of share-based compensation, including share options. The FASB has no authority to establish the manner in which enterprises compensate employees. As noted in Q8, an enterprise may reassess the costs and benefits of its existing employee share option plan. That reassessment may result in changes to existing employee compensation programs, including employee share option plans. A 2003 survey performed by a large public accounting firm indicates that many high-technology enterprises may reassess their employee compensation programs as a result of the Statement. However, hundreds of public companies have voluntarily adopted the fair-value-based method of Statement 123. Many of those enterprises have neither modified nor eliminated their employee share option plans, and some have modified the terms of new option grants to employees by, for example, shortening the contractual life of the option, or changing the vesting or exercise terms. In contrast, some enterprises have decided to eliminate their employee share option plans prospectively in favor of restricted share plans.

Q21. Why wasn't continued disclosure of the pro forma effects of employee share options adequate?

Some respondents to the Exposure Draft and the Invitation to Comment said that the pro forma disclosures required by Statement 123 provided adequate financial information about share-based payment arrangements with employees. Similar comments were made in various public venues during the Board's work leading to the issuance of the Statement. Some of those commentators asserted that whether information is disclosed in the notes or recognized in the financial statements is not important—either way, sophisticated users of financial information have access to the information they need.

The Board reaffirmed the conclusion in Statement 123 that pro forma disclosures are not an adequate substitute for recognition in the financial statements of compensation cost resulting from share-based payment arrangements with employees. FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* discusses recognition and disclosure in the context of accounting, explaining that recognition means including amounts in the totals of the financial statements. It goes on to state that disclosure is not the equivalent of recognition and is not a substitute for recognition for items that meet the recognition criteria.

Although the main reasons for the Board's conclusion are essentially the same as in Statement 123, new information made available since the issuance of Statement 123 provided additional support for the Board's reasoning. Most of the users of financial statements who responded to either the Exposure Draft or the Invitation to Comment, as well as those who responded to the IASB's ED2 or the Exposure Draft that led to the issuance of FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure,* strongly supported recognition of the cost of employee services received in exchange for equity instruments. Although the pro forma disclosures required by Statement 123 helped to mitigate the problems of nonrecognition of compensation cost, many financial statement users said that the failure of most entities to recognize that cost impaired the transparency, relevance, and comparability, as well as the credibility, of financial statements. In agreeing with those respondents, the Board noted that if disclosure and recognition were equal alternatives, the arguments for only disclosing the amount of compensation cost from share-based compensation arrangements with employees would apply equally to other costs incurred during a period, such as warranties, pensions, and other postretirement benefits. Disclosing but not recognizing those costs in the period in which they are incurred would cause reported net income to misrepresent the results of current operations.

In addition to responses to the Exposure Draft, the Invitation to Comment, ED2, and the Exposure Draft that led to the issuance of Statement 148, the Board's conclusion that many users of financial statements support recognition of the cost of employee services received in exchange for equity share options and similar equity instruments was confirmed in a number of ways, including:

1. Numerous requests from users for the Board to add a project to its agenda to reconsider accounting for share-based payment arrangements with employees.
2. Responses to a survey of analysts and fund managers in 2001 by the Association for Investment Management and Research[8] (now the CFA Institute) in which 83 percent of respondents favored recognition of compensation cost for share-based payment arrangements with employees.
3. Responses to a recent survey[9] of 30 institutional investors in technology companies in which more than 90 percent supported recognition of compensation cost for employee share options. Approximately 70 percent of those analysts and portfolio managers also said that an analysis of an entity's share options is significant to their valuation of the entity and has the potential to influence their investment decisions.

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[8]Association for Investment Management and Research (AIMR), "Survey on Accounting for Stock Options" (September 2001); electronic survey sent to more than 18,000 AIMR members worldwide to assess their response to a proposed agenda topic of the IASB.

[9]Merrill Lynch, "Tech Stock Options: The Invisible Cash Flow Drain" (February 3, 2004).

4. Public comments made by various users of financial statements during the course of the Board's project on share-based payment.

5. Numerous nonbinding shareholder resolutions in which both institutional and individual investors urged entities to adopt Statement 123's recognition provisions.

Q22. Is the Statement convergent with International Financial Reporting Standards?

The Statement is largely convergent with International Financial Reporting Standard (IFRS) 2, *Share-based Payment*. The Statement and IFRS 2 have the potential to differ in only a few areas. The more significant areas are briefly described below.

IFRS 2 requires the use of the modified grant-date method for share-based payment arrangements with nonemployees. In contrast, Issue 96-18 requires that grants of share options and other equity instruments to nonemployees be measured at the earlier of (1) the date at which a commitment for performance by the counterparty to earn the equity instruments is reached or (2) the date at which the counterparty's performance is complete.

IFRS 2 contains more stringent criteria for determining whether an employee share purchase plan is compensatory or not. As a result, some employee share purchase plans for which IFRS 2 requires recognition of compensation cost will not be considered to give rise to compensation cost under the Statement.

IFRS 2 applies the same measurement requirements to employee share options regardless of whether the issuer is a public or a nonpublic entity. The Statement requires that a nonpublic entity account for its options and similar equity instruments based on their fair value unless it is not practicable to estimate the expected volatility of the entity's share price. In that situation, the entity is required to measure its equity share options and similar instruments at a value using the historical volatility of an appropriate industry sector index.

In tax jurisdictions such as the United States, where the time value of share options generally is not deductible for tax purposes, IFRS 2 requires that no deferred tax asset be recognized for the compensation cost related to the time value component of the fair value of an award. A deferred tax asset is recognized only if and when the share options have intrinsic value that could be deductible for tax purposes. Therefore, an entity that grants an at-the-money share option to an employee in exchange for services will not recognize tax effects until that award is in-the-money.

In contrast, the Statement requires recognition of a deferred tax asset based on the grant-date fair value of the award. The effects of subsequent decreases in the share price (or lack of an increase) are not reflected in accounting for the deferred tax asset until the related compensation cost is recognized for tax purposes. The effects of subsequent increases that generate excess tax benefits are recognized when they affect taxes payable.

The Statement requires a portfolio approach in determining excess tax benefits of equity awards in paid-in capital available to offset write-offs of deferred tax assets, whereas IFRS 2 requires an individual instrument approach. Thus, some write-offs of deferred tax assets that will be recognized in paid-in capital under the Statement will be recognized in determining net income under IFRS 2.

Differences between the Statement and IFRS 2 may be further reduced in the future when the IASB and FASB consider whether to undertake additional work to further converge their respective accounting standards on share-based payment.

Q23. Does the Statement change U.S. tax law?

No, U.S. tax law is established by the U.S. government. The Statement has no impact on either federal or state tax law.

Q24. When does the Statement become effective?

For public enterprises that do not file as small business issuers, the Statement is effective as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. For public entities that file as small business issuers, the Statement is effective as of the beginning of the first interim or annual reporting period that begins after December 15, 2005. For nonpublic entities, the Statement is effective as of the beginning of the first annual reporting period that begins after December 15, 2005. Public entities, nonpublic entities, and small business issuers are defined in Appendix E of the Statement.

Upon adoption, in most cases, enterprises are required to use a modified version of prospective application. Under that transition method, compensation cost is recognized for the portion of awards for which the requisite service period has not yet been rendered, based on the grant-date fair value of those awards calculated for either recognition or pro forma disclosures under Statement 123. For periods before the required effective date, those entities may elect to apply a modified version of the retrospective application transition method under which financial statements for prior periods are adjusted on a basis consistent with the pro forma disclosures required for those periods by Statement 123.

APPENDIX A

Summary

The Statement addresses the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity in an exchange for goods or services incurs liabilities that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. The Statement focuses primarily on accounting for transactions in which an entity obtains employee services. The Statement does not change the accounting guidance for share-based payment transactions with parties other than employees provided in Statement 123 as originally issued and Issue 96-18. The Statement does not address the accounting for employee share ownership plans currently accounted for under SOP 93-6.

The Statement eliminates the ability to account for share-based compensation transactions using Opinion 25, and generally requires instead that such transactions be accounted for using a fair-value-based method.

Organization of Statement 123(R)

Statement 123(R) consists of the following sections:

1. Summary
2. Statement of Financial Accounting Standards No. 123 (revised 2004)
3. Appendix A—Implementation Guidance
4. Appendix B—Basis for Conclusions
5. Appendix C—Background Information
6. Appendix D—Amendments Made to Existing Pronouncements
7. Appendix E—Glossary
8. Appendix F—Status of Related Authoritative Literature

For a comprehensive discussion of the issues associated with the accounting for share-based payment transactions, refer to Statement 123(R).

Principal Reasons for Issuing the Statement

1. To address the concerns of users of financial statements, including institutional and individual investors, as well as many other parties, that Opinion 25's intrinsic value method results in financial statements that do not faithfully represent the economic transactions affecting the issuer, namely, the receipt and consumption of employee services in exchange for equity instruments.

2. To improve the comparability of reported financial information through the elimination of alternative accounting methods. Approximately 750 public companies have voluntarily adopted, or announced their intention to adopt, Statement 123's fair-value-based method of accounting for share-based payment transactions with employees. Other companies would continue to use Opinion 25's intrinsic value method. The Board believes that similar economic transactions should be accounted for similarly, and that such transactions should be accounted for using a fair-value-based method.

3. To simplify U.S. generally accepted accounting principles (GAAP) by requiring the use of a single method of accounting for share-based payment transactions and eliminating Opinion 25's intrinsic value method and its related detailed and form-driven rules.

4. To improve international convergence by accounting for share-based payment transactions in a manner similar to IFRS 2, that was issued by the IASB in February 2004. IFRS 2 requires that all entities recognize an expense for all employee services received in share-based-payment transactions, using a fair-value-based method that is similar in most respects to the fair-value-based method established in Statement 123 and the improvements made to it by the Statement. The IASB's standards are followed by companies in many countries around the world.

Key Accounting Provisions of the Statement

1. For public entities, the cost of employee services received in exchange for an award of equity instruments will be measured based on the grant-date fair value of those instruments (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award (usually the vesting period). No compensation cost will be recognized for equity instruments for which employees do not render the requisite service.

2. For public entities, the cost of employee services received in exchange for an award that qualifies as a liability will be based on the initial fair value of the award, and will be remeasured subsequently at each reporting date through settlement date. The change in fair value during the requisite service period will be recognized over that period.

3. For nonpublic entities, the cost of employee services received in exchange for an award of equity instruments will be measured based on the grant-date fair value of those instruments, except in certain circumstances. Specifically, if it is not practicable to estimate the entity's expected volatility of its share price, the entity will measure the equity instruments based on a value calculated by substituting the historical volatility of an appropriate industry sector index for

the expected volatility. That cost will be recognized over the period during which an employee is required to provide service in exchange for the award (usually the vesting period). No compensation cost will be recognized for equity instruments for which employees do not render the requisite service. The Statement allows nonpublic entities to elect to measure its liability awards at intrinsic value (rather than fair value) through the date of settlement.

4. The grant-date fair value of employee share options and similar instruments will be estimated using option-pricing models adjusted for the unique characteristics of those instruments (unless observable market prices for the same or similar instruments are available). If an equity award is modified after the grant date, incremental compensation cost will be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award before the modification.

5. Employee share purchase plans will not be considered compensatory if (a) the terms of those plans are no more favorable than those available to all holders of the same class of shares, or any purchase discount from the market price does not exceed the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering, (b) substantially all employees meeting limited employment qualifications can participate on an equitable basis, and (c) the plan incorporates no option features (with limited exceptions).

6. Excess tax benefits, as defined by the Statement, will be recognized as an addition to paid-in capital. Cash retained as a result of those excess tax benefits will be presented in the statement of cash flows as financing cash inflows. The write-off of deferred tax assets relating to unrealized tax benefits associated with recognized compensation cost will be recognized as income tax expense unless there are excess tax benefits from previous awards remaining in paid-in capital.

Disclosures

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

An entity with one or more share-based payment arrangements will provide information about:

1. The nature and terms of share-based payment arrangements that existed during the period and the potential effects of those arrangements on shareholders

2. The effect of compensation cost arising from share-based payment arrangements on the income statement

3. The method of estimating the fair value of goods or services received, or the fair value of the equity instruments granted, during the period

4. The cash flow effects resulting from share-based payment arrangements.

An entity that acquires goods or services other than employee services in share-based payment arrangements will provide similar disclosures. An entity that has multiple share-based payment arrangements with employees will disclose information separately for different types of awards to the extent that differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of share-based compensation.

Effective Dates and Transition

The Statement is effective:

1. For public entities that do not file as small business issuers—as of the beginning of the first interim or annual reporting period that begins after June 15, 2005

2. For public entities that file as small business issuers—as of the beginning of the first interim or annual reporting period that begins after December 15, 2005

3. For nonpublic entities—as of the beginning of the first annual reporting period that begins after December 15, 2005. The effective date for a nonpublic entity that becomes a public entity after June 15, 2005, and does not file as a small business issuer is the first interim or annual reporting period after the entity becomes a public entity. If the newly public entity files as a small business issuer, the effective date is the first interim or annual reporting period after December 15, 2005, for which the entity is a public entity.

As of the required effective date, all public entities and those nonpublic entities that used the fair-value-based method for either recognition or disclosure under Statement 123 will apply the Statement using a modified version of prospective application. Under that transition method, compensation cost is recognized for (1) all awards granted after the required effective date and to awards modified, cancelled, or repurchased after that date and (2) the portion of prior awards for which the requisite service has not yet been rendered, based on the grant-date fair value of those awards calculated for either recognition or pro forma disclosures under Statement 123. For periods before the required effective date, entities may elect to apply a modified version of retrospective application transition method under which financial statements for prior periods are adjusted on a basis consistent with the pro forma disclosures required for those periods by

Statement 123. Nonpublic entities that did not use the fair value method in Statement 123 for either recognition or pro forma disclosures are required to apply the prospective transition method as of the required effective date.

The cumulative effect of initially applying the Statement, if any, is recognized as of the required effective date.