

Financial Accounting Series

EXPOSURE DRAFT

Proposed Statement of Financial Accounting Standards

**Accounting for Stock-Based Compensation—
Transition and Disclosure**

an amendment of FASB Statement No. 123

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

Director of Major Projects and Technical Activities
File Reference No. 1101-001

Comment Deadline: November 4, 2002



Financial Accounting Standards Board
of the Financial Accounting Foundation

Responses from interested parties wishing to comment on the Exposure Draft must be *received* in writing by November 4, 2002. Responses received after that date will be distributed to Board members but will *not* be considered in the staff's analysis of comments that will be the basis for the Board's redeliberations. Interested parties should submit their comments by email to director@fasb.org, File Reference 1101-001. Those without email may send their comments to the "MP&T Director—File Reference 1101-001" at the address at the bottom of this page. Responses should *not* be sent by fax.

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**Notice for Recipients
of This Exposure Draft**

This proposed Statement would amend the transition and disclosure provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, but would not amend its recognition and measurement provisions. The Board invites comments relevant to those matters addressed by the proposed Statement. In particular, the Board invites comments on whether other disclosures about stock-based employee compensation cost would be useful—for example, the classification of that cost in the income statement.

The Board has been actively working with the International Accounting Standards Board (IASB) and other major national standard setters to bring about convergence of accounting standards across the major world capital markets. In that context, the Board and the FASB staff have been monitoring the IASB's deliberations on share-based payments and plan to issue an Invitation to Comment summarizing the IASB's proposal and explaining the key differences between its provisions and current U.S. accounting standards. The Board will then consider whether it should propose any changes to the U.S. standards on accounting for stock-based compensation.

Summary

This proposed Statement would amend FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, this proposed Statement would amend the disclosure requirements of Statement 123 to require more prominent disclosures about the method of accounting for stock-based employee compensation and the effect of the method used on reported results in both annual and interim financial statements.

Reasons for Issuing This Proposed Statement

Statement 123 requires prospective application of the fair value recognition provisions to new awards granted after the beginning of the period of adoption. When Statement 123 was issued in 1995, the Board recognized the potential for misleading implications caused by the “ramp-up” effect on reported compensation cost from prospective application of the fair value method of accounting for stock-based employee compensation to only new grants after the date of adoption. However, the Board was concerned that retroactive application would be excessively burdensome to financial statement preparers because the historical assumptions required to determine the fair value of awards of stock-based compensation for periods prior to the issuance of Statement 123 were not readily available. Because Statement 123 requires disclosure of the pro forma effect of applying the fair value method of accounting for those entities that continue to use the intrinsic value method of accounting, historical information about the fair value of awards granted since the original effective date of Statement 123 now is readily available.

A number of companies have recently adopted or announced their intention to adopt the fair value method of accounting for stock-based employee compensation. To respond to concerns raised by constituents, including financial statement preparers’ concerns about the ramp-up effect arising from the transition provisions of Statement 123 and financial statement users’ concerns about the lack of consistency and comparability in reported results, this proposed Statement would require new disclosures aimed at providing greater clarity of the effect of stock-based employee compensation on reported results. This proposed Statement also would require greater prominence of those disclosures.

How the Changes in This Proposed Statement Would Improve Financial Reporting

This proposed Statement would permit two additional transition methods for entities that adopt the preferable method of accounting for stock-based employee compensation. Both of those methods avoid the ramp-up effect arising from prospective application of the fair value method.

Also, in the absence of a single accounting method for stock-based employee compensation, this proposed Statement would provide greater comparability in reported financial information by requiring disclosure of comparable information for all companies regardless of whether, when, or how an entity adopts the preferable, fair value method of accounting. This proposed Statement would prescribe a specific tabular

format for disclosure of the pro forma effect of applying the fair value method of accounting for stock-based employee compensation in all periods presented and would provide greater prominence of that information by requiring disclosure in the “Summary of Significant Accounting Policies” or its equivalent. In addition, this proposed Statement would improve the timeliness of those disclosures by requiring their inclusion in condensed financial statements for interim periods.

International Convergence

The Board did not reconsider the recognition and measurement provisions of Statement 123 in the context of this project because of the ongoing International Accounting Standards Board (IASB) project on share-based payment. The IASB has concluded its deliberations on the accounting for share-based payments, including employee stock options, and has announced plans to issue a proposal for public comment in the fourth quarter of 2002. That proposal would require companies using IASB standards to recognize as an expense, starting in 2004, the fair value of employee stock options granted. While there are some important differences between the recognition and measurement provisions in the IASB proposal and those contained in Statement 123, the basic approach is the same—fair value measurement of stock-based employee compensation at the date of grant with expense recognition over the vesting period.

The Board has been actively working with the IASB and other major national standard setters to bring about convergence of accounting standards across the major world capital markets. In particular, the Board and the FASB staff have been monitoring the IASB’s deliberations on share-based payments and plan to issue an Invitation to Comment summarizing the IASB’s proposal and explaining the key differences between its provisions and current U.S. accounting standards. The Board will then consider whether it should propose any changes to the U.S. standards on accounting for stock-based compensation.

Proposed Statement of Financial Accounting Standards

Accounting for Stock-Based Compensation—Transition and Disclosure

an amendment of FASB Statement No. 123

October 4, 2002

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Proposed Statement of Financial Accounting Standards

Accounting for Stock-Based Compensation—Transition and Disclosure

an amendment of FASB Statement No. 123

October 4, 2002

INTRODUCTION

1. This Statement amends FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for an entity that voluntarily changes to the fair value method of accounting for stock-based employee compensation. It also amends the disclosure provisions of that Statement to require more prominent disclosure about the effects of an entity's accounting policy decisions with respect to stock-based employee compensation on reported net income. Finally, this Statement amends APB Opinion No. 28, *Interim Financial Reporting*, to require disclosure about those effects in interim financial information.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to Statement 123

Amendments to Transition Provisions

2. Statement 123 is amended as follows:

a. Paragraph 52 is replaced by the following:

If an entity elects to adopt the recognition provisions of this Statement for stock-based employee compensation, that change in accounting principle shall be reported using any one of the following methods:

- a. Apply the recognition provisions to all employee awards granted, modified, or settled after the beginning of the fiscal year in which the recognition provisions are first applied.
- b. Recognize stock-based employee compensation cost from the beginning of the fiscal year in which the recognition provisions are first applied as if the fair value based accounting method in this Statement had been used to account for all employee awards granted, modified, or settled in fiscal years beginning after December 15, 1994.
- c. Restate all periods presented to reflect stock-based employee compensation cost under the fair value based accounting method in this Statement for all employee awards granted, modified, or settled in fiscal years beginning after

December 15, 1994. Restatement of periods prior to those presented is permitted but not required.

Accounting for modifications and settlements of awards initially accounted for in accordance with Opinion 25 is discussed and illustrated in Appendix B. Awards are considered to be accounted for under Opinion 25 only if they were issued in fiscal periods beginning before December 15, 1994 (that is, the fair value of the awards was never required to be measured under this Statement).

- b. The following new paragraph 52A is inserted after paragraph 52:

An entity that elects the transition method in paragraph 52(b) or 52(c) may need to report an adjustment to additional paid-in capital as of the beginning of the first period for which stock-based employee compensation cost is accounted for in accordance with the fair value method. For awards that are unvested or, in the case of certain variable awards, unexercised as of the beginning of that period, that adjustment shall be determined as follows:

- a. The carrying amounts of unearned or deferred compensation (contra-equity accounts), stock-based compensation liabilities, and the related deferred tax balances recognized under Opinion 25, if any, shall be reversed.
- b. The additional paid-in capital, stock-based compensation liabilities, and related deferred tax balances determined under this Statement shall be recognized.
- c. The difference between the amounts reversed in (a) and the amounts recognized in (b) shall be reported as an adjustment to additional paid-in capital as of the beginning of the period. No cumulative effect of a change in accounting principle shall be presented.

- c. The following sentence is added to the end of paragraph 44:

If an entity that continued to apply Opinion 25 subsequently adopts the fair value based method in this Statement, only the additional paid-in capital recognized from excess tax deductions for awards accounted for under the fair value method pursuant to the transition provisions of paragraph 52 is available to absorb any such write-offs.

Amendments to Disclosure Provisions

- d. Paragraph 45 of Statement 123 is replaced by the following:

Regardless of the method used to account for stock-based employee compensation arrangements, the financial statements of an entity shall include the disclosures

specified in paragraphs 46–48. All entities shall disclose prominently, in the “Summary of Significant Accounting Policies” or its equivalent,^{*} the following information:

- a. The method used—either the intrinsic value method or the fair value method—to account for stock-based employee compensation in each period presented
- b. For an entity that adopts the fair value recognition provisions of this Statement, for all financial statements in which the period of adoption is presented, a description of the method of reporting the change in accounting principle
- c. If unvested awards of stock-based employee compensation were outstanding and accounted for under the intrinsic value method of Opinion 25 for any period for which an income statement is presented, a tabular presentation, for all periods, of the following information:
 - (1) Net income and basic and diluted earnings per share as reported
 - (2) The stock-based employee compensation cost, net of related tax effects, included in the determination of net income as reported
 - (3) The stock-based employee compensation cost, net of related tax effects, that would have been included in the determination of net income if the fair value method had been applied to all awards[†]
 - (4) Pro forma net income as if the fair value method had been applied to all awards
 - (5) Pro forma basic and diluted earnings per share as if the fair value method had been applied to all awards.

The required pro forma amounts shall reflect the difference in stock-based employee compensation cost, if any, included in net income in accordance with Opinion 25 and the related cost measured by the fair value method, as well as additional tax effects, if any, that would have been recognized in the income statement if the fair value method had been used. The required pro forma per share amounts shall reflect the change in the denominator of the diluted earnings per share calculation as if the assumed proceeds under the treasury stock method, including measured but unrecognized compensation cost and the excess tax benefits credited to additional paid-in capital, were determined under the fair value method.

^{*}APB Opinion No. 22, *Disclosure of Accounting Policies*, paragraph 15, introduces the term *Summary of Significant Accounting Policies* and expresses a preference for disclosure of accounting policies preceding the notes to financial statements or as the initial note.

[†]For purposes of applying the guidance in this Statement, *all awards* refers to awards granted, modified, or settled in fiscal periods beginning after December 15, 1994—that is, awards for which the fair value was required to be measured under this Statement.

Examples of the required tabular presentation are included in Appendix B.

- e. The second sentence of paragraph 53 is deleted.

Amendment to Opinion 28

- 3. The following is added to the list of disclosures in paragraph 30 of Opinion 28:
 - j. If any period presented includes the effects of stock-based compensation accounted for under the intrinsic value method, the following information about stock-based employee compensation expense under the provisions of FASB Statement No. [14X], *Accounting for Stock-Based Compensation—Transition and Disclosure*, shall be disclosed prominently in tabular form:
 - (1) Net income and basic and diluted earnings per share as reported
 - (2) The stock-based employee compensation cost, net of related tax effects, included in the determination of net income as reported
 - (3) The stock-based employee compensation cost, net of related tax effects, that would have been included in the determination of net income if the fair value method had been applied to all awards*
 - (4) Pro forma net income as if the fair value method had been applied to all awards
 - (5) Pro forma basic and diluted earnings per share as if the fair value method had been applied to all awards.

*For purposes of applying the guidance in this subparagraph, *all awards* refers to awards granted, modified, or settled in fiscal periods beginning after December 15, 1994—that is, awards for which the fair value was required to be measured under FASB Statement No. 123, *Accounting for Stock-Based Compensation*.

Effective Date

- 4. The amendments to Statement 123 in paragraphs 2(a)–2(d) of this Statement shall be effective for financial statements for fiscal years ending after December 15, 2002. Earlier application of the transition provisions in paragraphs 2(a)–2(c) is permitted if financial statements for a fiscal year ending prior to December 15, 2002, have not been issued as of the date this Statement is issued. Early application of the disclosure provisions in paragraphs 2(d) and 3 is encouraged.
- 5. The amendment to Statement 123 in paragraph 2(e) of this Statement and the amendment to Opinion 28 in paragraph 3 shall be effective for financial reports containing condensed financial statements for interim periods beginning after December 15, 2002.

<p>The provisions of this Statement need not be applied to immaterial items.</p>

Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

A1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes the reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

A2. Statement 123 was issued in 1995. In the deliberations that led to that Statement, the Board concluded that the fair value method of recognizing stock-based compensation expense was the preferable method of accounting, but, in an effort to end an extremely divisive debate between the Board and its constituents, the Board decided to permit the continued use of the intrinsic value method of accounting under APB Opinion No. 25, *Accounting for Stock Issued to Employees*. However, the Board decided to require companies to disclose the pro forma effect of applying the fair value method of accounting for stock-based employee compensation. Following the issuance of Statement 123, most companies continued to account for stock-based employee compensation using the intrinsic value method of accounting under Opinion 25.

A3. Prior to the issuance of Statement 123, companies had not been gathering the necessary information or making the necessary assumptions to measure the fair value of employee stock options. Therefore, although the Board acknowledged that the “ramp-up” effect¹ created by the prospective transition method was undesirable, the Board decided to require prospective application because retroactive application would have required preparers of financial statements to make numerous assumptions relevant to the valuation of previously issued stock-based awards.² In 2002, however, seven years after the issuance of Statement 123, historical information necessary for retroactive application of the recognition provisions of Statement 123 is available.

A4. A number of companies have recently elected to adopt the fair value recognition provisions of Statement 123 for stock-based employee compensation awards. In conjunction with those decisions, a number of companies, as well as financial statement users, expressed concern to the Board about the lack of comparability and consistency of

¹As Statement 123, paragraph 269, states, “Some respondents were concerned about the inherent ‘ramp-up’ effect on compensation cost as additional awards are granted and the first awards to which the new method applies move through their vesting periods.”

²Statement 123, paragraph 270, further states, “The Board recognizes the potential for misleading implications caused by the ramp-up effect of prospective application of a new accounting or pro forma disclosure requirement for a recurring transaction. . . . The Board decided that requiring retroactive application would be excessively burdensome.”

reported results between periods caused by the requirement to adopt the fair value method prospectively.

A5. In August 2002, the Board decided to add a limited-scope project to its agenda to reconsider the transition and disclosure provisions of Statement 123.

Basis for Conclusions

Transition Alternatives

A6. In its deliberations leading to the issuance of this Exposure Draft, the Board considered three possible transition methods in addition to the prospective application to new awards prescribed by Statement 123:

- a. Cumulative effect of a change in accounting principles under APB Opinion No. 20, *Accounting Changes*
- b. Retroactive restatement
- c. Prospective recognition for unvested awards and new awards.

Cumulative Effect of a Change in Accounting Principle

A7. The Board rejected the cumulative effect of a change in accounting principle method primarily because the cumulative effect, at best, would be the cumulative effect from the original issuance of Statement 123 and, therefore, would not represent a meaningful amount. In addition, some preparers and users of financial statements have expressed concern over the confusion often created by including the cumulative effect of a change in accounting principle in a current period. The Board also noted that the cumulative effect from this particular accounting change generally would result in a reduction in retained earnings offset by an increase in additional paid-in capital.

Retroactive Restatement

A8. *Retroactive restatement*, as used in this Statement, refers to the restatement of prior periods' reported net income to give effect to the fair value method of accounting for awards granted to employees in fiscal years beginning after December 15, 1994. Retroactive application to awards made in periods before that date involves the problems cited by the Board in originally rejecting retroactive application and would likely result in restated amounts different from those previously disclosed in financial statements.

A9. Some financial statement users suggested that the Board require retroactive restatement for reporting this change in accounting. Board members agreed that retroactive application maximizes consistency between periods and comparability among companies. Some preparers echoed the Accounting Principles Board's concerns expressed in Opinion 20 that the restatement of prior-period results detracts from the credibility of reported results.

Prospective Recognition for Unvested Awards and New Awards

A10. Some preparers suggested that both the ramp-up effect of prospective application and the perceived credibility issue of retroactive restatement could be avoided by prospectively applying the fair value recognition provisions of Statement 123 to the unvested portion of previously issued awards as well as new awards. Under that approach, the stock-based employee compensation cost recognized in the year of adoption would be the same as that which would be recognized if the company had applied the retroactive restatement method.

Multiple Transition Methods

A11. This Statement reflects the Board's decision to allow multiple transition methods. The Board acknowledges that preparers' and users' concerns are primarily related to the lack of comparability and consistency arising from the ramp-up effect resulting from prospective application. The Board further acknowledges that the existence of multiple transition methods will impair comparability of reported results. However, because a choice of accounting methods for stock-based employee compensation continues to exist—intrinsic value or fair value—comparability is impaired currently. Although information is now available to facilitate retroactive application, the Board notes that the guidance in Statement 123 is unambiguous—it requires prospective application to new awards granted after the beginning of the period of adoption. Therefore, the Board decided that it would be inappropriate, in the context of this project, to preclude the existing Statement 123 transition method, particularly for those companies that previously had decided to adopt the preferable method of accounting in accordance with that Statement.

A12. The Board agreed to permit both the retroactive restatement method and the prospective recognition method for unvested awards and new awards because (a) both methods address the ramp-up effect and (b) under either method, reported net income in the period in which the change is made and all subsequent periods will be the same. The Board decided not to *require* restatement for an entity that *voluntarily* adopts the preferable accounting method because, for the reasons cited in paragraph A11, concerns about comparability and consistency continue to exist. Although it continues to believe that disclosure is not a substitute for recognition in the financial statements, the Board believes that the amended disclosures required by this Statement, which apply to all companies other than those that elect retroactive restatement and which require disclosure of comparable information for all periods presented, provide information that will mitigate the lack of comparability in reported results caused by permitting alternative transition methods.

Accumulated Opinion 25 Balances

A13. The prospective recognition method for unvested awards (alternative (b) in paragraph 2(a) of this Statement) and the retroactive restatement method (alternative (c) in paragraph 2(a)) raise the issue of accounting for the accumulated deferred compensation, if any, and related deferred income tax balances that arose under the

application of Opinion 25. The Board concluded that the carrying amounts of those items should be reversed and that any required beginning balances under Statement 123 relating to unvested awards should be recorded with the effect recognized in paid-in capital. The Opinion 25 balances and Statement 123 balances both ultimately increase paid-in capital for the value of the employee services received. However, because the two accounting models under which those balances arise are fundamentally different, the Board decided not to require reclassifications between retained earnings (either directly or through the income statement) and paid-in capital because doing so would be tantamount to reporting the cumulative effect of a change in accounting principle that the Board believes would not provide useful information.

Accounting for Excess Tax Benefits

A14. Under Statement 123, deferred tax assets recognized in excess of the tax benefit ultimately realized from the exercise of employee stock options reduce net income unless there are accumulated balances in additional paid-in capital related to previous excess tax benefits related to awards accounted for under the fair value method of Statement 123. In that case, the write-off of those excess deferred tax assets reduces additional paid-in capital. Under the requirements of this Statement, the determination of whether sufficient excess tax benefits are accumulated in additional paid-in capital should be based on the excess tax benefits that are recorded in additional paid-in capital after adoption of the fair value method and that relate only to awards accounted for under the fair value method. Therefore, under either the prospective application to new awards method or the prospective recognition for unvested awards method, no excess tax benefits will be accumulated in additional paid-in capital as of the beginning of the period of adoption.

Prominence of Disclosures

A15. During the Board's deliberations on amending the transition provisions of Statement 123, a number of users of financial statements raised concerns about the consistency and comparability of reported results arising from the choice of accounting methods for stock-based employee compensation. The Board decided to address those concerns in the context of this project by improving the disclosures about the effects on reported results of accounting policy decisions related to stock-based employee compensation.

A16. The Board considered whether to require that the pro forma disclosures in paragraph 45 of Statement 123 be included on the face of the income statement. The Board considered existing FASB literature and other financial reporting guidance governing pro forma financial information (for example, the rules and regulations of securities regulators) and the proliferation of "pro forma" language in various public reports of financial performance. The Board decided not to require disclosure of the Statement 123 pro forma amounts on the face of the income statement. The Board noted that all financial statement disclosures required under generally accepted accounting principles are integral to the financial statements and necessary for a proper understanding of reported results, financial position, and cash flows.

A17. Acknowledging constituents' concerns about the possible lack of comparability, the Board concluded that all companies should be required to provide comparable information about stock-based employee compensation cost. Although disclosure is not an adequate substitute for recognition of items that qualify for recognition in financial statements, the Board believes that the disclosures required by this Statement will mitigate the disadvantages of permitting multiple transition methods. Therefore, the disclosures required by paragraph 2(d) of this Statement should be included in the financial statements of all entities that cover periods in which all or a portion of the cost of stock-based awards was determined under Opinion 25.

A18. Because some costs determined under Opinion 25 continue to appear in the financial statements of companies that voluntarily adopt the fair value recognition provisions of Statement 123, the Board decided that the disclosure requirements of paragraphs 2(d) and 3 of this Statement should apply to those companies during the transition period as well. However, entities that elect the retroactive restatement method will have no need to provide those pro forma disclosures.

A19. Because the disclosures required by paragraph 2(d) are intended to enhance comparability among companies, the Board concluded that those disclosures should be displayed prominently. Accordingly, the Board decided to require (a) that those disclosures be presented in the "Summary of Significant Accounting Policies" or its equivalent and (b) that the pro forma information be disclosed in tabular form. The Board acknowledges, however, that some companies may not have adopted the preferable method of disclosing accounting policies as expressed in paragraph 15 of APB Opinion No. 22, *Disclosure of Accounting Policies*, which states:

The Board recognizes the need for flexibility in matters of format (including the location) of disclosure of accounting policies provided that the reporting entity identifies and describes its significant accounting policies as an integral part of its financial statements in accordance with the foregoing guides in this Opinion. The Board believes that the disclosure is particularly useful if given in a separate *Summary of Significant Accounting Policies* preceding the notes to financial statements or as the initial note. Accordingly, it expresses its preference for that format under the same or a similar title.

The Board decided that those companies must disclose prominently the information required by this Statement. The Board also believes that those companies may wish to reconsider the method of disclosing accounting policies in light of the guidance in Opinion 22.

Interim Disclosures

A20. Paragraph 106 of Statement 123 states, in part:

If a need for pro forma disclosures on a quarterly basis becomes apparent, the Board will consider at a later date whether to require those disclosures.

Based on concerns expressed by investors and creditors and on research demonstrating the importance of interim financial reporting to timely decision making by investors, the Board concluded that the pro forma disclosures required under Statement 123 should be provided on a quarterly basis.

A21. Although quarterly financial information is not required to, and generally does not, include a “Summary of Significant Accounting Policies,” the Board decided that the pro forma information required by this Statement should be disclosed prominently in the notes to condensed financial statements for interim periods.

Effective Dates

A22. The Board decided that the alternative transition methods permitted by this Statement should be effective for fiscal years ending after December 15, 2002, with earlier application permitted to the extent that, upon issuance of a final Statement, a company has not already issued annual financial statements reflecting this change in accounting. Because one objective of this Statement is to respond to the concerns of preparers about the lack of consistency arising from the ramp-up effect, the Board concluded that immediate availability of this guidance and the transition methods it allows is appropriate.

A23. The annual disclosures required by this Statement are effective for financial statements for fiscal years ending after December 15, 2002. The Board believes that those disclosures are important to financial statement users and that the data needed to make those disclosures are readily available to preparers. Earlier application is encouraged for entities that, upon issuance of a final Statement, have not yet issued financial statements for a fiscal year ending before December 15, 2002.

A24. The disclosure provisions of this Statement for condensed financial statements for interim periods are effective for financial reports containing condensed financial statements for interim periods beginning after December 15, 2002. The Board considered the incremental cost of providing those disclosures and concluded that the benefit of those disclosures to investors and creditors outweighs that cost.

Appendix B

ILLUSTRATIVE GUIDANCE FOR APPLYING THE DISCLOSURE PROVISIONS OF THIS STATEMENT

B1. This appendix provides five examples of disclosures required under paragraphs 2(d) and 3 of this Statement. Three examples illustrate the disclosures required under the various transition methods permitted under this Statement, one example illustrates the amended disclosures required for a company that continues to apply the Opinion 25 intrinsic value method, and one example illustrates the disclosures required by this Statement in condensed financial statements for interim periods.

B2. The disclosures required by paragraphs 46–48 of Statement 123 are unaffected by this Statement. Examples of the disclosures required under those paragraphs are provided in Appendix B of Statement 123.

Illustration 1—Prospective Application to New Awards

B3. The following disclosures assume that the company has adopted the fair value method of accounting for stock-based employee compensation by applying the fair value recognition provisions of Statement 123 to all new awards granted after the beginning of 2002. For simplicity, this illustration also assumes that all previous awards were fixed stock options with no intrinsic value at the date of grant.

At December 31, 2003, the company has four stock-based employee compensation plans, which are described more fully in Note XX.³ Prior to 2002, the company had applied the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations in accounting for those plans. No stock-based employee compensation expense is reflected in 2001 net income as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Effective January 1, 2002, the company adopted the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, prospectively to all new awards granted to employees after January 1, 2002. Awards under the company's plans vest over periods ranging from three to five years. Therefore, the expense related to stock-based employee compensation included in the determination of net income for 2002 and 2003 is less than that which would have been recognized if the fair value method had been applied to all awards since the original effective date of Statement 123. The following table illustrates the effect on net income and earnings per share if the fair value method had been applied to all outstanding and unvested awards in each period.

³Note XX would include the disclosures required by paragraphs 46–48 of Statement 123.

	Year Ended December 31		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Net income, as reported	\$ 471,387	\$ 404,113	\$ 347,790
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	7,913	3,187	—
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, ⁴ net of related tax effects	<u>(18,902)</u>	<u>(12,747)</u>	<u>(10,962)</u>
Pro forma net income	<u>\$ 460,398</u>	<u>\$ 394,553</u>	<u>\$ 336,828</u>
Earnings per share:			
Basic—as reported	<u>\$2.62</u>	<u>\$2.27</u>	<u>\$1.97</u>
Basic—pro forma	<u>\$2.56</u>	<u>\$2.22</u>	<u>\$1.91</u>
Diluted—as reported	<u>\$1.99</u>	<u>\$1.72</u>	<u>\$1.49</u>
Diluted—pro forma	<u>\$1.94</u>	<u>\$1.68</u>	<u>\$1.44</u>

Illustration 2—Prospective Recognition for Unvested Awards and New Awards

B4. The following disclosures assume that the company has adopted the fair value method of accounting for stock-based employee compensation by applying the fair value recognition provisions of Statement 123 to all unvested awards as of the beginning of 2003 and new awards made after January 1, 2003. The company *has elected not to restate* earlier periods presented for comparative purposes. For simplicity, this illustration also assumes that all previous awards were fixed stock options with no intrinsic value at the date of grant.

At December 31, 2003, the company has four stock-based employee compensation plans, which are described more fully in Note XX. Prior to 2003, the company had applied the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations in accounting for those plans. No stock-based employee compensation expense was reflected in 2001 or 2002 net income as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Effective January 1, 2003, the company adopted the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, prospectively to all unvested employee awards as of January 1, 2003, and all new awards granted to employees after January 1, 2003. Under the method of adoption selected by the company, compensation expense recognized in 2003 is the same as that which would have been recognized had the recognition provisions of Statement 123 been applied from its original effective date. Results for prior years have not been restated.

⁴All awards refers to awards granted, modified, or settled in fiscal periods beginning after December 15, 1994—that is, awards for which the fair value was required to be measured under Statement 123.

The following table illustrates the effect on net income and earnings per share if the fair value method had been applied to all outstanding and unvested awards in each period.

	<u>Year Ended December 31</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Net income, as reported	\$ 460,398	\$ 407,300	\$ 347,790
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	18,902	—	—
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, ⁵ net of related tax effects	<u>(18,902)</u>	<u>(12,747)</u>	<u>(10,962)</u>
Pro forma net income	<u>\$ 460,398</u>	<u>\$ 394,553</u>	<u>\$ 336,828</u>
Earnings per share:			
Basic—as reported	<u>\$2.56</u>	<u>\$2.29</u>	<u>\$1.97</u>
Basic—pro forma	<u>\$2.56</u>	<u>\$2.22</u>	<u>\$1.91</u>
Diluted—as reported	<u>\$1.94</u>	<u>\$1.73</u>	<u>\$1.49</u>
Diluted—pro forma	<u>\$1.94</u>	<u>\$1.68</u>	<u>\$1.44</u>

Illustration 3—Retroactive Restatement

B5. The following disclosures assume that the company has adopted the fair value method of accounting for stock-based employee compensation in 2003 and *has elected to restate* all periods presented. For simplicity, this illustration also assumes that all previous awards were fixed stock options with no intrinsic value at the date of grant.

At December 31, 2003, the company has four stock-based employee compensation plans, which are described more fully in Note XX. Prior to 2003, the company had applied the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations in accounting for those plans. No stock-based employee compensation expense was reflected in previously reported results as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Effective January 1, 2003, the company adopted the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, for stock-based employee compensation. All prior periods presented have been restated to reflect the compensation expense that would have been recognized had the recognition provisions of Statement 123 been applied to all awards granted to employees after January 1, 1995.

⁵Refer to footnote 4 to this Statement.

Illustration 4—Continued Accounting under Opinion 25

B6. The following disclosures assume that the company continues to account for stock-based employee compensation using the intrinsic value method under Opinion 25. For simplicity, this illustration also assumes that all previous awards were fixed stock options with no intrinsic value at the date of grant.

At December 31, 2003, the company has four stock-based employee compensation plans, which are described more fully in Note XX. The company applies the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations in accounting for those plans. No stock-based employee compensation expense is reflected in net income as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

	<u>Year Ended December 31</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Net income, as reported	\$ 479,300	\$ 407,300	\$ 347,790
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, ⁶ net of related tax effects	<u>(18,902)</u>	<u>(12,747)</u>	<u>(10,962)</u>
Pro forma net income	<u>\$ 460,398</u>	<u>\$ 394,553</u>	<u>\$ 336,828</u>
Earnings per share:			
Basic—as reported	<u>\$2.66</u>	<u>\$2.29</u>	<u>\$1.97</u>
Basic—pro forma	<u>\$2.56</u>	<u>\$2.22</u>	<u>\$1.91</u>
Diluted—as reported	<u>\$2.02</u>	<u>\$1.73</u>	<u>\$1.49</u>
Diluted—pro forma	<u>\$1.94</u>	<u>\$1.68</u>	<u>\$1.44</u>

⁶Refer to footnote 4 to this Statement.

Illustration 5—Interim Disclosures

B7. The following disclosures assume that, during the third quarter of its fiscal 2003, a company with a September 30 year-end adopts the fair value method of accounting for stock-based employee compensation as of the beginning of fiscal 2003 by applying the fair value recognition provisions of Statement 123 to unvested awards as of October 1, 2002, and all new awards granted after October 1, 2002. The company *has elected not to restate* earlier periods presented. For simplicity, this illustration also assumes that all previous awards were fixed stock options with no intrinsic value at the date of grant.

During the third quarter of fiscal 2003, the company adopted the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, for stock-based employee compensation, effective as of the beginning of the fiscal year. Under the method of adoption selected by the company, stock-based employee compensation expense recognized in 2003 is the same as that which would have been recognized had the fair value recognition provisions of Statement 123 been applied to all awards granted after October 1, 1995. Results for prior years have not been restated. The following table illustrates the effect on net income and earnings per share as if the fair value method had been applied to all outstanding and unvested awards in each period.

	3 Months Ended		9 Months Ended	
	June 30		June 30	
	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>
Net income, as reported	\$ 115,100	\$ 101,825	\$ 345,299	\$ 305,475
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	4,725	—	14,177	—
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, ⁷ net of related tax effects	<u>(4,725)</u>	<u>(3,187)</u>	<u>(14,177)</u>	<u>(9,560)</u>
Pro forma net income	<u>\$ 115,100</u>	<u>\$ 98,638</u>	<u>\$ 345,299</u>	<u>\$ 295,915</u>
Earnings per share:				
Basic—as reported	<u>\$0.64</u>	<u>\$0.57</u>	<u>\$1.92</u>	<u>\$1.72</u>
Basic—pro forma	<u>\$0.64</u>	<u>\$0.55</u>	<u>\$1.92</u>	<u>\$1.66</u>
Diluted—as reported	<u>\$0.49</u>	<u>\$0.43</u>	<u>\$1.45</u>	<u>\$1.29</u>
Diluted—pro forma	<u>\$0.49</u>	<u>\$0.42</u>	<u>\$1.45</u>	<u>\$1.25</u>

⁷Refer to footnote 4 to this Statement.