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Financial Accounting Series

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*

Comments are requested by February 1, 2003.

Financial Accounting Standards Board
of the Financial Accounting Foundation

Responses from interested parties wishing to comment on the Invitation to Comment must be *received* in writing by February 1, 2003. Interested parties should submit their comments by email to director@fasb.org, File Reference No. 1102-001. Those without email may send their comments to the "MP&T Director—File Reference 1102-001" at the address at the bottom of this page. Responses should *not* be sent by fax.

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November 18, 2002

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

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EXECUTIVE SUMMARY

This Invitation to Comment is being issued by the Financial Accounting Standards Board (FASB or Board) to solicit comments on certain issues that the Board will discuss when, in accordance with its objectives of improving U.S. financial accounting and reporting standards and promoting international convergence of high-quality accounting standards, it considers whether it should propose any changes to the U.S. accounting standards on stock-based compensation. The Board believes this Invitation to Comment will also be useful to constituents that are planning to respond to the International Accounting Standards Board (IASB) Proposed International Financial Reporting Standard, *Share-based Payment* (Proposed IFRS).

This Invitation to Comment solicits views on the differences between certain U.S. accounting standards on stock-based compensation, principally FASB Statement No. 123, *Accounting for Stock-Based Compensation,* and its related interpretations, and the Proposed IFRS. Moreover, this Invitation to Comment uses those differences to solicit views on other aspects of accounting for stock-based compensation at fair value.

This Invitation to Comment analyzes similarities of and differences between Statement 123[1] and the Proposed IFRS with respect to accounting for stock-based compensation using a fair value based method. The similarities and differences are categorized by scope, recognition, measurement, disclosure, and transition. This Invitation to Comment does not compare Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees,* with the Proposed IFRS because Opinion 25 is not based on the fair value method of accounting for stock-based compensation, but on the intrinsic value method (refer to paragraph 2 of this Invitation to Comment).

Statement 123 and the Proposed IFRS have many similarities and differences. The most important similarities of the standards[2] are as follows:

- Equity Instruments—Both standards conclude that equity instruments, including stock options granted to employees, are valuable.
- Measurement Objective—Both standards establish fair value as the measurement objective for goods or services received.
- Measurement Date for Transactions with Employees—Both standards require that the fair value of equity instruments granted to employees be measured at the grant date.
- Attribution—Both standards require that compensation in the form of equity instruments granted to employees be recognized in the income statement over the period in which the employees provide services to earn the related benefits (generally, the vesting period).

The most important differences between Statement 123 and its related interpretations and the Proposed IFRS are as follows:

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[1]The term *Statement 123* includes Statement 123 and all its related interpretations.

[2]As used in this Invitation to Comment, the terms *both standards* or *the standards* refer to Statement 123 and its related interpretations and the Proposed IFRS.

- Issuance and Forfeitures—The standards put a completely different emphasis on the notion of issuance: Statement 123 is based on the premise that equity instruments are issued only when valuable consideration has been exchanged, and the Proposed IFRS acknowledges that issuance has no effect on its conclusions, regardless of how it is defined. Statement 123's notion of issuance is directly linked to its method of accounting for forfeitures. The Proposed IFRS's method of treating forfeitures is based on an entirely different rationale. This difference results in forfeitures being accounted for in two distinct manners. For example, Statement 123 reverses cumulative compensation expense for equity instruments that are forfeited, and the Proposed IFRS does not reverse that expense (refer to paragraphs 30–37 of this Invitation to Comment).
- Measurement Date for Transactions with Nonemployees—The standards prescribe different dates to measure the fair value of equity instruments granted for transactions with nonemployees when the fair value of the equity instruments issued is more reliably measurable than the fair value of the goods or services received (refer to paragraphs 23–29 of this Invitation to Comment).
- Attribution—The standards use different methods to attribute compensation expense over the period in which benefits are earned. This results in a difference in the total amount of cumulative compensation expense being recognized over the life of the award and in different expense recognition patterns over the life of the award (refer to paragraphs 39–60 of this Invitation to Comment).
- Income Tax Benefits—The standards treat excess tax benefits (tax benefits in excess of those associated with recognized cumulative compensation expense) differently. Statement 123 states that excess tax benefits should be recognized as additional paid-in capital; the Proposed IFRS states that all tax benefits should be recognized in the income statement (refer to paragraphs 79–82 of this Invitation to Comment).
- Employee Stock Ownership Plans (ESOPs)—ESOPs are excluded from the scope of Statement 123 and are accounted for in accordance with American Institute of Certified Public Accountants (AICPA) Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans.* ESOPs are included in the scope of the Proposed IFRS (refer to paragraph 15 of this Invitation to Comment).
- Nonpublic Entities—Statement 123 permits nonpublic entities to measure equity instruments granted at minimum value for transactions with employees, whereas the Proposed IFRS requires that all entities, both public and nonpublic, measure equity instruments at fair value for transactions with employees (refer to paragraph 38 of this Invitation to Comment).

It is important to note that both standards are principles based; however, they differ because they are founded on different principles:

- Statement 123's main objective is to account for stock-based compensation by measuring and recognizing the fair value of goods or services acquired in exchange for equity instruments. With respect to transactions with employees, the objective is achieved by using a modified grant-date fair value measurement method, which is a hybrid of grant-date and vesting-date measurement methods: grant date because the fair value of the award is initially determined at its grant date, and vesting date because compensation cost related to the award is adjusted for subsequent events such as actual forfeitures and actual outcomes of performance conditions. The philosophical focus of Statement 123's measurement method is on the equity instruments given.

- The Proposed IFRS's main objective is to account for stock-based compensation by measuring and recognizing the fair value of goods or services received in exchange for equity instruments. With respect to transactions with employees, the objective is achieved by using a form of the grant-date fair value measurement method as a practical expedient. That measurement method does not have characteristics of a vesting-date measurement method. The philosophical focus of the Proposed IFRS's measurement method is on the services received.

This Invitation to Comment summarizes the primary and secondary similarities and differences, but it does not purport to be a comprehensive listing of all similarities and differences between Statement 123 and the Proposed IFRS. This Invitation to Comment was designed to encourage and facilitate a full analysis of the Proposed IFRS by the FASB's constituents. Such analysis is important because of the FASB's objective of promoting international convergence of high-quality accounting standards. Comments received in response to this Invitation to Comment will be used by the FASB when it considers whether changes should be proposed to U.S. accounting standards on stock-based compensation. **Responding to this Invitation to Comment is not a substitute for responding to the IASB about its Proposed IFRS; the FASB will not be responding to the IASB's Proposed IFRS. The FASB encourages all constituents to participate in the international accounting standard-setting process by responding directly to the IASB.**

ISSUES FOR RESPONDENTS

The FASB is soliciting comments on this Invitation to Comment to obtain constituent input on matters that should be considered in determining whether changes should be proposed to U.S. accounting standards on stock-based compensation. Unlike a comprehensive Discussion Memorandum, this Invitation to Comment does not address all of the issues associated with accounting for stock-based compensation. Also, the Board has not deliberated the issues or observations contained in this Invitation to Comment, which it would do prior to issuing an Exposure Draft. The Board will consider comments received when it discusses whether changes should be proposed to U.S. accounting standards on stock-based compensation. The Board expects to add a project to its agenda in the near term to reconsider the accounting for stock-based compensation. If the Board deems that changes should be proposed to U.S. accounting standards on stock-based compensation, then an Exposure Draft of a proposed standard will be issued. That Exposure Draft would incorporate the Board's decisions about those matters.

The Board requests comments on any of the issues related to the similarities of and differences between U.S. accounting standards on stock-based compensation and the Proposed IFRS discussed in this Invitation to Comment. Respondents are urged to explain the basis for their views. As stated, an Invitation to Comment is not as comprehensive as a Discussion Memorandum; this Invitation to Comment describes those differences the FASB staff has identified. Respondents are also encouraged to comment on any differences not identified in this Invitation to Comment if they feel those differences are significant.

The Board reminds respondents that commenting on the Invitation to Comment is not a substitute for commenting on the Proposed IFRS; the FASB will not be responding to the IASB's Proposed IFRS. The FASB encourages all constituents to actively participate in the international standard-setting process by responding to the IASB's request for comments on its Proposed IFRS.

The Board is sensitive to the many issues related to stock-based compensation and to the diverse views of constituents on this matter. The Board believes a project on stock-based compensation is the most suitable forum for the evaluation and discussion of those issues and views. Because this Invitation to Comment is focused on Statement 123 and the Proposed IFRS and both standards contain important similarities, the Board is not seeking comments on certain issues: (a) whether stock options granted to employees result in compensation expense for the issuing entity, (b) whether stock options issued to employees should be measured at something other than fair value, (c) whether the fair value of stock options can be reliably measured (except as noted in Issue 2), and (d) the appropriate measurement date for measuring the fair value of equity instruments granted to employees. The paragraph below describes the Board's rationale for not seeking comments on items (a)–(d).

With respect to item (a), the FASB, in 1995, and the IASB have both concluded that employee stock options represent something of value, the issuance of which results in compensation expense. In reaching that conclusion, the FASB and the IASB analyzed the arguments against this proposition in great detail and did not find such arguments persuasive. With respect to item (b), the FASB, in 1995, determined that stock options issued to employees should be measured at fair value rather than intrinsic value. The IASB also has come to this same conclusion. Both Boards[3] have found arguments against this position to be flawed, because a stock option's value consists of both intrinsic and time value. With respect to item (c), the FASB, in 1995, and the IASB concluded that the fair value of stock options can be reliably measured through the use of option-pricing models. While the Board is aware of the various issues inherent in the use of those models, it believes that the compensation cost calculated using them produces decision-useful information for financial statement users. However, the Board is interested in receiving suggestions on how application of option-pricing models and the consistent use of key assumptions might be improved to provide better estimates of compensation expense. Item (d) has been discussed on several occasions: by the APB (early 1970s), by the FASB (early 1990s), and by the IASB (early 2000s). In each case, deliberations have resulted in a conclusion by the APB, FASB, and IASB that the value of equity instruments awarded to employees should be measured at grant date (except in the case of variable awards under Opinion 25). Arguments for other measurement dates have been evaluated by the FASB and the IASB in great detail, as described in the bases for conclusions of Statement 123 and the Proposed IFRS. Because Emerging Issues Task Force (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," provides different measurement-date criteria for nonemployee awards than the Proposed IFRS, respondents are encouraged to comment with respect to that difference. The Board welcomes comments on all matters; therefore, while the Board is not seeking comments on items (a)–(d), comments received relating to them will be included in the staff's analysis of comments.

Each section of the Invitation to Comment incorporates issues the Board would like respondents to consider. A complete list of those issues has been included in Appendix B.

Responses from interested parties wishing to comment on the Invitation to Comment must be *received* in writing by February 1, 2003. Interested parties should submit their comments by email to director@fasb.org, File Reference No. 1102-001. Those without email may send their comments to the "MP&T Director—File Reference No. 1102-001" at the address in the inside cover of this Invitation to Comment. Responses should *not* be sent by fax.

[3]The term *Boards* refers to both the FASB and the IASB.

FOREWORD

This is the first Invitation to Comment issued by the FASB that compares an IASB exposure draft of a Proposed IFRS with existing U.S. accounting standards; it was prepared to emphasize the importance of the IASB's efforts to establish high-quality financial reporting standards and to encourage open deliberation and discussion on the product of those efforts. The FASB expects to issue similar Invitations to Comment on different topics in the future as the FASB and IASB consider other projects of mutual interest.

The principal author is Michael W. Tovey, practice fellow on the research and technical activities staff of the FASB. Significant contributions were made by other members of the FASB research and technical activities staff, including Jules Cassel, senior technical advisor; Patrick G. Durbin, practice fellow; Michael J. Maffei, postgraduate technical assistant; Mary Huydic, editing coordinator; and Donna Lorenti, word processing specialist; and by members of the IASB, including James J. Leisenring, board member, and Kimberley Crook, project manager. In addition, other FASB senior staff members assisted in the preparation of this Invitation to Comment.

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*

BACKGROUND

1. This Invitation to Comment is issued by the Financial Accounting Standards Board (FASB or Board) to solicit comments on certain issues that the Board will discuss when, in accordance with its objectives of improving U.S. financial accounting and reporting standards and promoting international convergence of high-quality accounting standards, it considers whether it should propose any changes to the U.S. accounting standards on stock-based compensation.[4] An Invitation to Comment identifies issues prior to the development of an Exposure Draft of a Statement of Financial Accounting Standards. This Invitation to Comment solicits views on the similarities and differences between certain U.S. accounting standards on stock-based compensation and the International Accounting Standards Board (IASB) Proposed International Financial Reporting Standard (IFRS), *Share-based Payment.* Moreover, this Invitation to Comment uses those differences to solicit views on other aspects of accounting for stock-based compensation at fair value.

2. This Invitation to Comment focuses on comparing FASB Statement No. 123, *Accounting for Stock-Based Compensation* (Statement 123), and its related interpretations, with the Proposed IFRS because both standards have as their foundation the recognition of stock-based compensation using a fair value method. In developing Statement 123, the Board determined that recognizing stock-based compensation using a fair value based method is the preferable method of accounting for such compensation. While Statement 123 permits an entity to account for certain stock-based employee compensation arrangements using the intrinsic value based method in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees,* this Invitation to Comment does not analyze the differences between Opinion 25 and the Proposed IFRS because the method in Opinion 25 diverges from the preferable method and from potential international convergence of high-quality accounting standards.

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[4]U.S. accounting standards on stock-based compensation comprise Opinion 25 and all its related interpretations (refer to Appendix C); Statement 123 and all its related interpretations, including EITF Issues No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services," and No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"; and AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans.*

Opinion 25

3. Opinion 25 was issued in October 1972 and specifies that stock-based employee compensation be recorded at the award's intrinsic value at grant date for awards that meet certain criteria. Since 1972, a large body of guidance has been developed to apply the rules set forth in Opinion 25 under various circumstances.[5] Nevertheless, as noted by Statement 123, "Opinion 25 has been criticized for producing anomalous results and for providing little general guidance to use in deciding how to account for new forms of stock-based employee compensation plans."[6] This led to a request by various constituents for the FASB to reconsider the accounting required in Opinion 25. The result of that reconsideration is Statement 123.

Statement 123

4. In June 1993, the FASB issued an Exposure Draft on accounting for stock-based compensation. The Exposure Draft proposed requiring all entities to use a fair value based method of accounting that would have "(a) resulted in accounting for stock-based employee compensation that was both internally consistent and also consistent with accounting for all other forms of compensation [that is, it would have been expensed], (b) 'leveled the playing field' between fixed and variable awards, and (c) made the accounting for equity instruments issued to employees more consistent with the accounting for all other free-standing equity instruments and the related consideration received."[7] This Exposure Draft was intensely opposed by various constituents. In December 1994, in the face of likely congressional intervention into the standard-setting process, the Board determined that the deliberate, logical consideration of issues that is absolutely essential for the development of high-quality, concept-based accounting standards could not be achieved under such circumstances. Eventually, in October 1995, the FASB issued Statement 123, which gives entities the choice of accounting for stock-based employee compensation using a fair value based method or intrinsic value based method under Opinion 25.

5. Statement 123 specifies that it is preferable to recognize compensation cost for all stock-based employee compensation at fair value but not required. However, Statement 123 requires that all entities disclose in the notes to the financial statements the pro forma effect on net income and earnings per share of reporting stock-based employee compensation using the preferable method. Paragraph 62 of Statement 123 states in part:

> The Board chose a disclosure-based solution for stock-based employee compensation to bring closure to the divisive debate on this issue—not because it believes that solution is the best way to improve financial accounting and reporting.

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[5]For a complete list of the Interpretations of Opinion 25 and related Emerging Issues Task Force issues, refer to Appendix C of this Invitation to Comment.

[6]Refer to paragraphs 4 and 5 of Statement 123.

[7]Statement 123, paragraph 57; footnote reference omitted.

Since Statement 123 was issued, few entities had adopted the preferable method prior to 2002. Recent corporate scandals characterized by allegations of executive misconduct have once again focused the attention of investors, the U.S. Congress, and the media on the accounting for stock-based compensation arrangements. Many are demanding that compensation expense associated with those arrangements be recognized in the income statement. Some market participants are reacting to those demands: as of November 14, 2002, the Dow Jones News Service reported that 117 companies[8] have elected, or have announced plans, to adopt the preferable method of accounting for stock-based employee compensation. That is, they have elected to account for stock-based employee compensation under the fair value based method specified in Statement 123. Statement 123 and certain related interpretations have been included in this Invitation to Comment as Appendixes D–F.

IASB

6. The IASB was formed in 2001 and is the standard-setting arm of the International Accounting Standards Committee Foundation (IASCF), which also was formed in 2001. Those two entities were established as a result of the reorganization of the International Accounting Standards Committee (IASC), which was founded in 1973. The IASB is based in London and is funded by contributions from large accounting firms, financial institutions, and industrial concerns throughout the world; central and development banks; and other international and professional organizations. The IASB board consists of 12 full-time and 2 part-time members from 9 countries and various functional backgrounds. The IASB's main objective can be summarized as follows: The IASB "is committed to developing, in the public interest, a single set of high-quality, global accounting standards that require transparent and comparable information in general purpose financial statements. In pursuit of this objective, the [IASB] cooperates with national accounting standard-setters to achieve convergence in accounting standards around the world."[9]

Exposure Draft of IASB Proposed IFRS, *Share-based Payment*

7. The IASB noted that while the use of share-based payment[10] has increased, neither the IASB nor many countries developed standards that address the accounting for share-based payment. Further, accounting for share-based payment touches on several complex recognition and measurement issues. In July 2000, the G4+1[11] issued a position paper, *Accounting for Share-Based Payment*. Investors and other users of financial statements

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[8]"Table of Companies Expensing Stock Options," Dow Jones News Service, November 14, 2002.

[9]*International Accounting Standards 2002,* "Introduction," page 1.

[10]The term *share-based payment* is equivalent to *stock-based compensation* defined in Statement 123. Statement 123, paragraph 2, states, "This Statement uses the term *compensation* in its broadest sense to refer to the consideration paid for goods or services, regardless of whether the supplier is an employee or not." Those terms may be used interchangeably; however, this Invitation to Comment uses *stock-based compensation* as a generic term to denote all forms of payment in amounts based on the price of the entity's common stock or other equity instruments.

[11]The G4+1 was a group of standard setters that included representatives from the accounting standards boards of Australia, Canada, New Zealand, the United Kingdom, and the United States and from the IASC.

that responded to the IASB on the position paper strongly supported the notion that share-based payment transactions represent an expense that should be recognized in the income statement when the goods or services received are consumed. Many constituents of national standard setters have expressed the view that accounting for share-based payment should be addressed at an international level to avoid perceived competitive disadvantages associated with a national standard setter proposing changes in isolation from other national standard setters. In addition, the International Organization of Securities Commissions stated that the IASC should address accounting for share-based payment. For these reasons, in July 2001, the IASB added a project on share-based payment to its agenda, noting that the current environment provided it with an opportunity to provide international leadership on an impartial basis with respect to accounting for share-based payment. Since July 2001, the IASB has discussed various aspects of share-based payment, resulting in the exposure draft of a Proposed IFRS, *Share-based Payment,* issued in November 2002. The Proposed IFRS has been included in this Invitation to Comment as Appendix G.

International Convergence

8. The FASB and the IASB, as part of their respective missions, have the goal of promoting international convergence of high-quality accounting standards. This mutual goal, taken to its end, is intended to result in a single set of high-quality accounting standards recognized as authoritative by all national standard setters and national regulators and enforceable in all countries. International convergence of high-quality accounting standards will (a) result in financial statements comparable across all countries and capital markets, (b) improve financial statement transparency, (c) create a level economic-information playing field among all financial statement preparers, (d) reduce capital-market access costs, and (e) enhance the understandability of financial statements. The most important benefit is to enhance the usefulness of financial information; thus, financial statement users can make better economic decisions.

9. The FASB has been working actively with the IASB and other major national standard setters to bring about convergence of accounting standards across the major world capital markets. The FASB is accomplishing this work by establishing joint projects and a protocol for managing those projects, sharing information on current projects, and considering existing international accounting standards when developing new accounting standards. The issuance of this Invitation to Comment is indicative of the FASB’s commitment to promoting international convergence of high-quality accounting standards.

PRIMARY AND SECONDARY SIMILARITIES AND DIFFERENCES

Identification of Similarities and Differences

10. This Invitation to Comment addresses similarities of and differences between Statement 123[12] and the Proposed IFRS identified by the FASB staff. This Invitation to Comment places emphasis on the differences rather than the similarities because similarities indicate that a potential agreement around convergence to an accounting solution has taken place.[13] A discussion of the main similarities has been included in this Invitation to Comment to provide respondents with a general understanding of them. This Invitation to Comment does not purport to discuss all the similarities and differences. Stock-based compensation comes in many forms. Statement 123 has been in effect since 1996; consequently, an established body of application and implementation guidance supports that standard. Statement 123 requires entities that continue to apply Opinion 25 to provide pro forma disclosures to reflect the impact on net income and earnings per share as if they had adopted the preferable method. This practical experience has created a well-developed understanding of how the concepts within Statement 123 apply to idiosyncratic stock-based compensation arrangements. The Proposed IFRS has not yet been tested in practice. As such, the full ramifications of the concepts established in the Proposed IFRS will not be known until such time as they have been put into effect. Differences in the underlying concepts of the standards can provide a strong basis for understanding different results that may arise through the application and implementation of those concepts, but they will not identify all such different results. Respondents are asked to identify any additional differences not addressed in this Invitation to Comment that they believe are significant.

Primary and Secondary Classifications

11. Because of the large number of similarities of and differences between the two standards, this Invitation to Comment classifies them as primary or secondary. Items are classified as primary or secondary based on subjective considerations such as conceptual importance and potential magnitude of impact on reported financial results. Generally, most similarities have been classified as secondary because they have little or no potential impact on the reported financial results, not because they are conceptually unimportant. Primary similarities and differences are discussed within the main body of this Invitation to Comment, and secondary similarities and differences are discussed in Appendix A of this Invitation to Comment.

Structure of Standards

12. Statement 123 provides accounting guidance by the topics of nonemployee and employee stock-based compensation arrangements. The Proposed IFRS provides

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[12] As mentioned earlier, the term *Statement 123* includes Statement 123 and all its related interpretations.

[13] *Potential* is used here to indicate that the IASB's conclusions may change until a final IFRS is issued.

accounting guidance by the topics of the settlement features of stock-based compensation arrangements: for example, equity-settled share-based payment transactions, cash-settled share-based payment transactions, and share-based payment transactions with settlement alternatives. Because of the different formats of each standard, similarities and differences have been classified in this Invitation to Comment into five general categories: scope, recognition, measurement, disclosure, and transition. The scope category contains issues pertaining to the nature of the transactions subject to both standards.[14] The recognition and measurement categories contain issues associated with recognizing stock-based compensation transactions in the financial statements and measuring those transactions. The disclosure category includes those issues relating to financial statement disclosures, and the transition category includes those issues relating to the respective transition provisions of each standard.

INTRODUCTION

13. Statement 123 and the Proposed IFRS are similar in many respects. They are based on the same fundamental conclusions: (a) they both conclude that equity instruments, including stock options, are valuable, (b) they both require that equity instruments granted to employees should be measured at grant-date fair value, and (c) they both require that compensation for equity instruments granted to employees be recognized in the income statement over the period in which the employees provide services to earn the related benefit. However, the standards are different in many respects. The Proposed IFRS uses a different measurement-date concept for equity instruments issued to nonemployees, it uses a different attribution model to recognize compensation expense for employee and nonemployee transactions, and it requires recognition of all income tax benefits received in the income statement. This Invitation to Comment attempts to be neutral; it attempts to make no judgment as to the superiority of a principle or method of application espoused by either standard. However, this Invitation to Comment has been written from the perspective of Statement 123: generally, it identifies a similarity or difference, it describes the accounting treatment prescribed by Statement 123, it contrasts that accounting treatment to that prescribed by the Proposed IFRS, and it makes observations, inferences, or conclusions based on such analysis. Evaluating the Proposed IFRS from the perspective of Statement 123 has been deemed to be the most useful format and analysis for the FASB's constituents. The purpose of this Invitation to Comment is to discuss the similarities of and differences between the standards so respondents can gain a sufficient knowledge of them to provide comments to the Board and the IASB regarding those issues noted.

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[14] As mentioned earlier, *both standards* or *the standards* refers to both the U.S. accounting standard on stock-based compensation and the Proposed IFRS.

SCOPE

14. The scopes of the standards are different on three primary items: employee stock ownership plans (ESOPs), employee stock purchase plans (ESPPs), and transactions subject to Opinion 25.

ESOPs

15. ESOPs are defined in the U.S. tax code and are peculiar to the United States. They are accounted for in accordance with AICPA Statement of Position (SOP) 93-6, *Employers' Accounting for Employee Stock Ownership Plans.* ESOPs are excluded from the scope of Statement 123, although Statement 123's basis for conclusions does not explicitly address the reason for that scope exclusion. Some assert that it is because SOP 93-6 already required that compensation expense be measured at the fair value of the equity instruments at the date they are issued to employees. The IASB concluded that, in principle, there was no reason to treat different types of employee stock purchase plans (which would include ESOPs) differently.[15,16]

ESPPs

16. ESPPs are broad-based plans that encourage employee stock ownership. They are not ESOPs, as defined in U.S. tax code, and are not in the scope of SOP 93-6. In Statement 123, the Board found merit in arguments that small discounts from market price are equivalent to (a) discounts routinely offered to stockholders and others or (b) avoided stock issuance costs incurred in a public offering. As a result, the Board determined that certain ESPPs are not compensatory if they meet the following criteria: (1) they do not contain option features except for those explicitly permitted by the standard, (2) the discount from the market price is within certain parameters, and (3) substantially all full-time employees can participate.[17] The IASB considered, but rejected, an approach that would have made a scope exclusion for plans in which the discount offered is small.[18] The IASB noted that defining the meaning of small in this context is problematic; in addition, it noted that an argument could be made that rights

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[15]Refer to paragraphs BC8–BC15 of the Proposed IFRS.

[16]A discussion of how accounting for ESOPs would be affected under the Proposed IFRS is beyond the scope of this Invitation to Comment; however, the Proposed IFRS's grant-date measurement method and units-of-service attribution method would appear to have some impact in accounting for nonleveraged and leveraged ESOPs.

[17]Refer to paragraphs 23 and 24 of Statement 123.

[18]Refer to paragraphs BC8–BC15 of the Proposed IFRS.

given to employees with no significant value would likely be immaterial and, thus, would not need a specific exclusion.[19]

Issue 1: Statement 123 provides a scope exclusion for ESOPs and certain ESPPs, and the Proposed IFRS does not. Which view do you support and why?

Opinion 25

17. Opinion 25 applies to certain stock-based compensation arrangements with employees. It specifies that stock-based compensation transactions be measured at their intrinsic value on the date at which both (a) the number of equity instruments the employee is entitled to and (b) the option or stock price are known. Statement 123 permits an entity to account for those arrangements under Opinion 25. As previously stated, this Invitation to Comment does not compare Opinion 25 with the Proposed IFRS. This paragraph has been included here to alert constituents that this is a difference between Statement 123 and the Proposed IFRS (refer to paragraphs 2 and 3 of this Invitation to Comment).

RECOGNITION

18. Primary similarities or differences were identified relating to recognition of stock-based compensation. However, they are addressed in the measurement section of this Invitation to Comment for purposes of logical flow (refer to paragraphs 39–78 of this Invitation to Comment). Secondary similarities and differences are described in Appendix A of this Invitation to Comment.

MEASUREMENT

19. Both standards prescribe fair value as the measurement objective for stock-based compensation and require the use of option-pricing models for measuring the fair value of stock options, in the absence of market prices. It is in measurement concepts that the two standards differ to a large extent. Most of the primary differences between the standards are observed in the application of those measurement concepts.

Similarities

Option-Pricing Models

20. A mutual characteristic of the standards is that the fair value of stock options granted to employees must be measured using an option-pricing model that takes into

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[19]Paragraph 12 of the IASB's *Preface to Statements of International Accounting Standards* states, "International Accounting Standards are not intended to apply to immaterial items." Paragraph 30 of the IASB's *Framework for the Preparation and Presentation of Financial Statements* states, "Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement."

account the following six factors at grant date: the exercise price, the expected life of the option, the current price of the underlying stock, the expected volatility of the underlying stock, expected dividends on the underlying stock, and the risk-free interest rate.[20] Both the FASB and the IASB determined that option-pricing models produce measurements that are sufficiently reliable for inclusion in the financial statements (refer to paragraph 21 of this Invitation to Comment). The bases for conclusions of the standards fully discuss why the Boards came to that conclusion.[21] The FASB made its decision based, in part, on two points: (a) billions of dollars of transactions take place in options and other markets that use option-like instruments (the pricing of those transactions is often based on complex mathematical models such as the Black-Scholes model) and (b) the imprecision associated with using option-pricing models would not necessarily be greater than the imprecision inherent in other complex accruals, including those for pensions and other postretirement benefits. The IASB followed a similar rationale. The standards do not require the use of one specific option-pricing model; in fact, both standards note that one model may produce more reliable results in some circumstances than another model and that better models may be developed in the future.

21. Some argue that option-pricing models, which were developed for use in estimating the fair value of short-term, transferable instruments, do not produce reliable fair value measurements for long-lived, nontransferable employee options that are subject to service or performance conditions. For reasons described in the bases for conclusions of both standards, the IASB and the FASB considered and rejected those arguments. For example, both the IASB and the FASB noted that option-pricing models are used in estimating the value of both short- and long-term transferable options. Using option-pricing models to value long-term stock options increases the importance of selecting the appropriate measure of volatility. The IASB and the FASB acknowledged the importance of volatility assumptions in measuring the fair value of long-lived options and, accordingly, provided guidance for use in making volatility assumptions. Further, both the IASB and the FASB acknowledged that the nontransferability of employee options has an effect on the fair value of those options. Thus, the standards require that the outcomes of the option-pricing models be adjusted by using the expected life of stock options rather than the contractual life. The IASB and the FASB acknowledged the importance of estimating the expected life of employee options and thus provided supplemental guidance for use in making those assumptions.[22]

Issue 2: In measuring the fair value of stock options granted to employees, both Statement 123 and the Proposed IFRS require use of an option-pricing model that takes into account six specific assumptions. The standards provide supplemental guidance for use in selecting those assumptions.

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[20]Refer to paragraph 17 of Statement 123 and paragraph 22 of the Proposed IFRS.

[21]Refer to paragraphs 107–117 and 161–173 of Statement 123 and paragraphs BC129–BC190 and BC288–BC294 of the Proposed IFRS.

[22]Refer to paragraphs 271–287 of Statement 123 and paragraphs 20–25 of the Proposed IFRS. In addition, refer to the IASB Implementation Guidance, which is not expected to form part of the final IFRS.

Issue 2(a): Do you believe that an accounting standard should mandate the use of an option-pricing model for measurement purposes? If not, what other approaches do you believe would provide more consistent and reliable estimates of the fair value of employee stock options granted and why?

Issue 2(b): If you agree that an accounting standard should mandate the use of an option-pricing model, do you believe that a particular model should be mandated? If so, which model should be required to be used and why?

Issue 2(c): If you agree that an accounting standard should not mandate the use of a particular option-pricing model, do you believe that additional disclosures should be made to improve the user's ability to compare the reported financial results of different enterprises? If so, what types of additional information should be required to be disclosed?

Issue 2(d): Statement 123 and the Proposed IFRS require that certain modifications be made to the outcome of an option-pricing model to address certain features of employee stock options. If you believe that other modifications should be made to improve the consistency and reliability of those outcomes, please describe those modifications and why they should be required.

Issue 2(e): Do you believe that additional guidance for selecting the factors used in option-pricing models is necessary to provide added consistency and comparability of reported results? If so, what types of guidance should be provided and in which areas?

Differences

Measurement Philosophy

22. There is a subtle difference in the measurement philosophies of each standard. Fair value of equity instruments awarded is the measurement objective of each standard. Statement 123 states, "Equity instruments issued to employees and the cost of the services received as consideration shall be measured and recognized based on the fair value of the equity instruments issued."[23] In other words, the value of consideration received (or goods or services received) is deemed equal to the value of the equity instruments issued; thus, the measurement focus of Statement 123 is on the fair value of the equity instruments. The Proposed IFRS states, "For equity-settled share-based payment transactions, the entity shall measure the goods or services received, and the corresponding increase in equity, either directly, at the *fair value* of the goods or services received, or indirectly, by reference to* the fair value of the *equity instruments granted*, whichever fair value is more readily determinable."[24] The footnote (*) to paragraph 7 of the Proposed IFRS states, "This [draft] IFRS uses the phrase 'by reference to' rather than 'at,' because the fair value of the equity instruments granted is used to derive the deemed

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[23]Paragraph 16 of Statement 123.

[24]Paragraph 7 of the Proposed IFRS.

fair value of each unit of service received. . . ." The Proposed IFRS considers the fair value of equity instruments granted to be a surrogate measure of the fair value of goods or services received. This concept supports the Proposed IFRS's use of a form of grant-date measurement method as a practical expedient to achieve its measurement objective, which is to determine the value of the goods or services to be received (that is, the change in net assets that will result from goods or services received); because the value of those goods or services is not known or reliably measurable (or readily determinable), the value of the consideration given is being measured. Hence, the measurement focus of the Proposed IFRS is on the fair value of the goods or services received (without further reference to the fair value of equity instruments except at grant date). This difference results in substantive differences between the standards discussed in other sections of this Invitation to Comment, including the treatment of forfeitures and methods of attributing compensation.

Measurement Date—Transactions with Nonemployees

Statement 123

23. Statement 123 does not prescribe the measurement date to be used when measuring the fair value of equity instruments granted in nonemployee transactions. In the basis for conclusions, the Board observed that the distinction between grant date and vesting date may not be clearly present in nonemployee transactions; it depends on the facts and circumstances.[25] Relatively soon after the issuance of Statement 123, the EITF began deliberations on the date that should be used to measure the fair value of equity instruments granted to nonemployees. The result of those deliberations, 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," stipulates that the stock price of an equity award is fixed on the earlier of (a) the date a performance commitment is reached or (b) the date performance is complete. The latter clause generally provides for the assertion that measurement occurs on the vesting date of the equity instruments granted. The method established in Issue 96-18 is referred to as the modified vesting-date approach in this Invitation to Comment (in contrast to the modified grant-date approach established in Statement 123 for employee transactions). The modified vesting-date approach is consistent with the spirit of the Board's conclusion in Statement 123: the modified vesting-date approach is broad enough to encompass the complex contractual factors that often exist in nonemployee transactions.

Proposed IFRS

24. The Proposed IFRS states that the fair value of goods or services received are measured on the date these goods are obtained or the counterparty renders services; in the case of nonemployee transactions, it presumes that the fair value of goods or services received will be more readily determinable than the fair value of the equity instruments granted. This approach is distinct from Statement 123, which does not elevate this notion to a presumption. If the fair value of goods or services is not more readily determinable

[25]Refer to paragraphs 10 and 72 and 73 of Statement 123.

and the presumption is rebutted, an entity must measure the goods or services received at the grant-date fair value of the equity instruments granted. In those circumstances, the IASB concluded that measuring the fair value of the equity instruments at grant date is a practical expedient to achieving its accounting objective: to measure the fair value of the goods or services received. In reaching that conclusion, the IASB considered the FASB's rationale in Statement 123 as well as the guidance in Issue 96-18. The IASB saw no conceptual difference between employee and nonemployee transactions; in either case, an entity receives goods or services in exchange for granting equity instruments.[26] In accordance with its conclusion that there is no conceptual difference between the two types of transactions, the IASB determined that employee and nonemployee transactions should be recognized and measured in the same manner.

25. From the IASB's conclusion one can draw several inferences about the Proposed IFRS's design with respect to cases in which the fair value of equity instruments is more readily determinable than the fair value of the goods or services received:

a. The full value of economic benefits to be received in exchange for equity instruments granted was contemplated by the entity and the counterparty at the time the contractual arrangements were entered into (that is, the terms at grant date embody the full expectation of value of the arrangement and those terms were fairly bargained).
b. The full value of economic benefits received can be articulated as a monetary amount.
c. The monetary amount of the economic benefits to be received is presumed to be equal to the fair value of the equity instruments granted and fixed at grant date (refer to paragraph 44 of this Invitation to Comment).

26. Proponents of a modified vesting-date approach generally disagree with the first and third premises. They argue that service and performance conditions significantly affect the value of economic benefits; therefore, it is not possible to comprehend the value contemplated in those transactions until the service and performance conditions are accomplished. As a consequence, the monetary amount of the economic benefits received is not fixed at grant date.

27. The difference described in paragraph 24 of this Invitation to Comment between Statement 123 and the Proposed IFRS also affects measurement in nonemployee transactions in which one or more terms are not known. In those cases, the Proposed IFRS does not require any modification to the value of the award as is required under Issue 96-18.

28. Because the two approaches can result in different measurement dates for similar nonemployee transactions, there are several ramifications:

a. The total compensation expense recognized under Statement 123 will likely be different from that recognized under the Proposed IFRS.

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[26]Refer to paragraphs BC98–BC104 and BC122–BC128 of the Proposed IFRS.

b. Calculating compensation cost under the Proposed IFRS may be less difficult than under Statement 123 because it will be done only once, rather than at each reporting date prior to reaching a final measurement date.
c. Earnings reported under the Proposed IFRS will generally be less volatile than under Statement 123 because compensation cost related to an equity award is fixed at grant date under the Proposed IFRS, whereas under Issue 96-18, compensation cost related to an equity award may be variable for multiple reporting periods.

29. The difference in measurement-date rationale for nonemployee transactions under both standards is significant. It hinges on the FASB's and the EITF's implicit conclusion that transactions between employees and nonemployees are conceptually distinct, in that nonemployee transactions may create instances in which the distinction between grant date and vesting date is not clearly present. The IASB did not recognize such a distinction between transactions with nonemployees and employees.

Issue 3: Do you believe that employee and nonemployee transactions are distinct and, therefore, warrant different measurement dates for determining the fair value of equity instruments granted? If so, why? If not, why not?

Issue 4: Do you believe that the fair value of equity awards granted to nonemployees that include performance conditions can be measured with sufficient reliability to justify a grant-date measurement method? If so, why? If not, why not?

Issuance and Forfeitures

Issuance

30. Included within the recognition principle of Statement 123 is the notion of issuance; that is, equity instruments are not issued until the issuer has received valuable consideration (for example, cash or other assets) in exchange for the equity instruments. As a result, equity instruments subject to service or performance conditions are granted but not issued because they represent a conditional obligation to issue equity instruments in exchange for valuable consideration at a later date.[27] This notion is subtle, but very important to the theoretical underpinnings of Statement 123's measurement principles: it provides the conceptual basis for (a) the method used by Statement 123 to account for forfeitures (refer to paragraph 31 of this Invitation to Comment) and (b) the method used by Statement 123 to account for performance-based awards (refer to paragraph 50 of this Invitation to Comment). Indeed, this notion provides the conceptual basis the Board used to create the modified grant-date method used in Statement 123, which is a hybrid of grant-date and vesting-date measurement methods.[28] The Proposed IFRS does not explicitly address the notion of issuance except in the footnote to paragraph BC14 of the basis for conclusions:

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[27]Refer to footnote 4 of Statement 123 for further discussion on the notion of issuance.

[28]Refer to paragraphs 96 and 158 of, and the dissents to, Statement 123. As implied by the dissent, Statement 123 uses a notion of issuance that is consistent with a vesting-date measurement method, not a grant-date measurement method.

> The word 'issue' is used in a broad sense. For example, a transfer of shares held in treasury (own shares held) to another party is regarded as an 'issue' of equity instruments. Some argue that if options or shares are granted with vesting conditions, they are not 'issued' until those vesting conditions have been satisfied. *However, even if this argument is accepted, it does not change the Board's conclusions on the proposals in the draft IFRS, and therefore the word 'issue' is used broadly, to include situations in which equity instruments are conditionally transferred to the counterparty, subject to the satisfaction of specified vesting conditions.* [Emphasis added.]

The Proposed IFRS does not focus on the notion of issuance because conceptually it focuses on measuring the changes in net assets that results when goods or services are received; this focus is based on the IASB's conceptual framework. The Proposed IFRS's basis for conclusions provides additional insight into the rationale provided in the footnote to paragraph BC14:

> However, the Board noted that even if one accepts that the option is not issued until vesting date, this does not mean that there is no equity interest until then. If an equity interest exists before vesting date, that interest should not be remeasured. Moreover, the conversion of one type of equity interest into another should not, in itself, cause a change in total equity, because no change in net assets has occurred.[29]

From the citations above, changes in net assets do not result from the issuance of equity instruments; rather, they result from the receipt of goods and services. In contrast to Statement 123, the Proposed IFRS concludes the notion of issuance does not impact its accounting conclusions.

Issue 5: Do you believe the notion of issuance is conceptually of importance in the design of a standard on stock-based compensation? If so, why? If not, why not?

Issue 6: Do you believe an equity instrument subject to vesting or other performance conditions is issued, as defined by Statement 123, at the grant date? If so, why? If not, why not?

Forfeitures

Statement 123

31. Forfeitures are equity instruments granted that do not vest[30] for failure to achieve service or performance conditions. Statement 123 does not permit an entity to consider the effect of forfeiture when estimating the fair value of an equity instrument because forfeiture does not affect the value of an equity instrument at issuance (refer to paragraph

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[29]Refer to paragraph BC100 of the Proposed IFRS.

[30]The term *vest* means to earn the rights to. Refer to the comparative glossary in Appendix I.

30 of this Invitation to Comment).[31] In other words, an entity that issues an equity award to an employee will not adjust the grant-date fair value of an equity instrument for the possibility of future forfeitures. However, Statement 123 addresses the effect of forfeitures through the notion of issuance, which affects the quantity of equity instruments ultimately issued (refer to the example in paragraphs 34–36 of this Invitation to Comment). Statement 123 permits an entity the choice between two methods of accounting for the effect of forfeitures on the quantity of equity instruments granted. At grant date, an entity can estimate the amount of equity instruments expected to be forfeited and true up that estimate based on actual forfeitures. It is also acceptable for an entity to not estimate expected forfeitures but to recognize forfeitures as they occur. The Board agreed to the second method for cost-benefit considerations. The same aggregate amount of compensation cost is recognized under both methods, but the amounts recognized in any single period will differ. Those methods are based on the premise that equity instruments granted subject to service and performance conditions are not issued (refer to paragraph 30 of this Invitation to Comment) until after all valuable consideration is received. Forfeited equity instruments are not deemed issued for accounting purposes;[32] therefore, Statement 123 recognizes compensation cost based on the number of equity instruments actually issued. No compensation cost is recognized for instruments granted that are not issued because of failure to achieve service or performance conditions.

Proposed IFRS

32. The Proposed IFRS is based on the fundamental premise that changes in net assets result in changes in equity, which is based on the IASB's conceptual framework. The Proposed IFRS does not address forfeitures in terms of issuance like Statement 123 (refer to paragraph 31 of this Invitation to Comment); rather, it addresses forfeitures through their effect on changes in net assets, which includes their effect on the fair value of equity instruments granted and their effect on total compensation expense through the Proposed IFRS's attribution model. This philosophical difference results in different accounting treatment for vesting conditions and actual forfeitures. With respect to vesting conditions, the IASB concluded that vesting conditions (regardless of type) impact the fair value of rights to equity instruments; therefore, the grant-date fair value of equity instruments should take into account the possibility of forfeiture.[33] This means that an entity must consider the effect of forfeiture by incorporating it into the option-pricing model or by adjusting the model's output in estimating the fair value of each option at grant date. This approach is distinct from Statement 123: Statement 123 notes that the possibility of forfeiture does not impact the valuation of equity instruments when they are issued. Moreover, the effect of forfeiture is incorporated into the Proposed IFRS's attribution method, which takes into account expected forfeitures in calculating the grant-date fair value of services to be received during the vesting period. In other words, if one considers that employee compensation expense under the Proposed IFRS is a function of price (the grant-date fair value of equity instruments) and quantity (the amount of

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[31] Refer to paragraphs 17 and 166–168 of Statement 123.

[32] Refer to footnote 4 of Statement 123 for further discussion on the notion of issuance.

[33] Refer to paragraph BC171 of the Proposed IFRS.

services to be received during the vesting period), both price and quantity are adjusted for the effect of forfeiture; this is fully discussed in paragraphs 39–60 of this Invitation to Comment.

33. Consistent with the Proposed IFRS's measurement objective, the Proposed IFRS requires that services be accounted for when received (that is, when changes in net assets occur). Thus, compensation expense is recognized as services are received and consumed. When equity instruments are forfeited as a result of failure to achieve service or performance conditions, the Proposed IFRS states that forfeitures do not alter the fact that an entity has received (and consumed) services as consideration for an equity instruments.[34] In addition, the Proposed IFRS states that forfeitures do not represent a change in net assets. Essentially, the IASB treats the services received related to forfeited equity instruments as a contribution. Thus, compensation expense recognized by an entity related to forfeited equity instruments is not reversed under the Proposed IFRS. This conclusion is fundamentally different from Statement 123, in which such compensation expense is reversed because the equity instruments are considered not to have been issued for accounting purposes. Because compensation cost is measured based on the number of units-of-service received, a corollary to the Proposed IFRS's measurement objective is that no accounting is required when no services are received. For example, when an employee quits for another opportunity and stock options are forfeited as a result, no additional services will be received from that employee and, therefore, no additional compensation will be recognized. This corollary is important because it acts through the Proposed IFRS's attribution method in a similar manner to Statement 123's mechanism for truing up compensation cost for actual forfeitures, only not to the same extent (because recognized compensation cost is not reversed under the Proposed IFRS); this is fully discussed in paragraphs 39–60 of this Invitation to Comment.

Example

34. To illustrate the difference between the two standards, consider the following example. An entity grants 10 stock options, which vest at the end of 3 years of service, to each of 10 employees (100 stock options in total), and the entity uses an option-pricing model to determine the grant-date fair value per option of $12 (this per-option value has not been adjusted for the possibility of forfeiture). The entity expects that 20 percent of the options will not vest. Ultimately, 50 percent of the options do not vest due to an unusual amount of turnover in the year prior to vesting.

35. Under Statement 123, the entity must use the grant-date fair value of $12 to determine the total cost of the award. The entity elects to estimate at the grant date the effect of forfeitures on compensation cost rather than allocate the maximum of compensation expense over the service period and adjust for actual forfeitures as they occur. The total value of the award at grant date is $960 ($12 fair value per option × 80 options expected to vest). No compensation cost is recognized for options that are expected to be forfeited. Because 50 percent of the options ultimately vest, the entity

[34]Refer to paragraph BC207 of the Proposed IFRS.

recognizes cumulative compensation expense of $600 ($12 fair value per option × 50 options that actually vest).

36. Under the Proposed IFRS, the entity must consider the effect of forfeiture on the grant-date fair value per option; therefore, the entity calculates that fair value of each option as $9.60 ($12 × (100% – 20%)). It is important to note that the fair value per option under Statement 123 is $12, in contrast to $9.60 under the Proposed IFRS. The difference in fair values per option is due to how the effect of forfeiture is treated under the standards (refer to paragraph 32 of this Invitation to Comment). The fair value of the award at grant date is $960 ($9.60 fair value per option × total options in the award). No further adjustment to the option's grant-date fair value is made for actual forfeitures; however, actual forfeitures can indirectly affect the compensation recognized through the Proposed IFRS's attribution model. Compensation cost is recognized for services received in the period prior to forfeiture (refer to paragraphs 39–60 of this Invitation to Comment). Consequently, the number of options that actually vest has no impact on the amount of compensation for each unit-of-service received that is recognized in the income statement under the Proposed IFRS, and recognized compensation expense related to services received is not reversed under the Proposed IFRS if options are forfeited. Effectively, the units-of-service received from employees that vest and those that do not vest are considered of equal value.[35] Therefore, in the example presented, the fact that 50 percent of the options do not vest does not affect the amount of compensation recognized for each unit-of-service received. If the entity receives all of the units-of-service it expected to receive, it would recognize cumulative compensation expense of $960. If the entity did not receive all of the units-of-service that it expected to receive (because there was an unusual amount of employee turnover, as in the example presented), it would recognize some amount of cumulative compensation expense related to the units-of-service actually received that would be less than $960, for example, $850.[36] The difference of $110 ($960 – $850) represents the deemed fair value of services expected to be received that were not actually received.

37. Because the standards use different approaches in accounting for forfeitures, an entity reporting under Statement 123 may recognize a different amount of compensation expense for equity instruments issued than an entity reporting under the Proposed IFRS.

Issue 7: Do you believe that the effect of forfeiture should be incorporated into the estimate of fair value per equity instrument (IASB approach)? If so, why? If not, why not?

Issue 8: Should failure of an award holder to satisfy the conditions that entitle the holder to retain or receive the promised benefits affect the amount of compensation expense that should be recognized related to that reward? If so, why? If not, why not?

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[35]This, however, may not always be the case (refer to paragraph 48 of this Invitation to Comment).

[36]Paragraphs 39–78 of this Invitation to Comment explain how the Proposed IFRS's attribution method functions, including how units-of-service are calculated.

Nonpublic Entities

38. In Statement 123's basis for conclusions, the Board concluded that estimating expected volatility for the stock of a newly formed entity that is rarely traded, even privately, is not feasible. Based on this conclusion, Statement 123 allows a nonpublic entity[37] the choice of measuring the value of equity instruments granted to employees at the fair value or the minimum value,[38] which does not take into account expected volatility.[39] The IASB considered this issue and concluded differently. The main principle of the Proposed IFRS is that stock-based compensation should be measured at its fair value. Because the minimum value does not take into account expected volatility, it is not fair value. The IASB concluded that it is feasible to estimate expected volatility of the stock of a nonpublic entity and suggests several methods of estimation: valuing shares based on net assets, valuing shares based on earnings, and valuing shares based on share prices of similar public companies. The IASB acknowledges that such estimates are subjective and would likely understate volatility estimates; however, it believes that the resulting measure using such estimates would be closer to fair value than alternative measurements such as minimum value.[40]

Issue 9: Do you agree that the result of the IASB's approach to calculate the fair value of equity instruments of nonpublic entities would be closer to fair value than minimum value? If so, why? If not, why not?

Attribution of Compensation Cost—Transactions with Employees

Service-Based Awards

Statement 123

39. The attribution method prescribed by Statement 123 is based on the principle that compensation cost is attributed to expense over the period in which the employee provides service to earn the related benefit. If equity instruments are granted to employees and no service period is defined, the service period is presumed to be the period from grant date to vesting date. For cliff-vesting equity instruments, the attribution method results in attribution of compensation expense over the service period on a straight-line basis.[41] For graded-vesting equity instruments, Statement 123 gives a choice of two methods based on how the entity values the equity instrument:[42]

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[37]Refer to the comparative glossary in Appendix I.

[38]Refer to the comparative glossary in Appendix I.

[39]Refer to paragraphs 20 and 174–178 of Statement 123.

[40]Refer to paragraphs BC137–BC143 of the Proposed IFRS.

[41]The term *cliff-vesting* is used to describe equity awards that fully vest at the end of the vesting period, as opposed to the term *graded-vesting,* which is used to describe equity awards that fully vest in portions throughout the vesting period.

[42]Refer to paragraphs 30 and 31 and 201–203 of Statement 123.

- If the equity instruments are valued as a series of awards and each award in the series is valued using its estimated life, an entity must attribute compensation cost using the multiple-award approach described in FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*. For example, an entity issues 90 stock options to an employee, and 30 options vest at the end of each of the next 3 years. The entity views the single award of 90 options as a series of awards (3 awards each of 30 options that vest over 1, 2, and 3 years, respectively). Historical evidence indicates that employees generally exercise their options one year after the vesting date. In valuing the options, the entity values each award, or tranche, in the series using a different expected life (for example, 2 years[43] for the first tranche of 30 options, 3 years for the second, and 4 years for the third). The entity must attribute expense using the multiple-award approach. Using the same facts as above, at the end of year 1, the entity would recognize compensation expense in the amount of 100 percent of the value of the first tranche of 30 options, plus 50 percent of the value of the second tranche of 30 options, plus 33 percent of the value of the third tranche of 30 options.
- If the equity instruments are valued as a single award using an average estimated life, an entity may attribute compensation expense using the multiple-award approach described in Interpretation 28 or the entity may attribute compensation cost using the single-award approach (on a straight-line basis). Assuming the same facts as above, the entity values each tranche using the weighted-average expected life of the total award, which is three years. In this case, the entity may elect to attribute compensation cost in the same manner described in the example above, or it may attribute compensation cost on a straight-line basis (33.3 percent per year).

Regardless of which of the above methods is used, the compensation expense recognized at any date must be at least equal to the total compensation cost related to vested equity instruments at that date.

Proposed IFRS

40. The Proposed IFRS is based on a similar premise: an entity recognizes assets (goods or services) when received.[44] Effectively, this is equivalent to the Statement 123 approach to recognizing compensation expense over the period in which the employee performs services to earn the related benefit. Both standards share this general principle, but the Proposed IFRS requires that attribution of compensation cost be based on the units-of-service method.[45] The proposed units-of-service attribution method is a logical extension, in light of the Proposed IFRS's objective of accounting for services received

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[43]Two years represents the expected life of the first tranche of 30 options because historical evidence indicates that exercise takes place generally 1 year after the vesting date. Since the first tranche of 30 options vests in 1 year, another year is added to obtain the 2-year expected life. The expected life for the second and third tranches is calculated in the same manner.

[44]Both the IASB and FASB conceptual frameworks include the notion that services received represent assets received; however, since those services are generally consumed instantaneously, they are immediately expensed.

[45]Refer to the comparative glossary in Appendix I.

and its treatment of forfeitures. A unit-of-service is a standard amount used to measure the economic benefits from services received; it is stated in terms of a particular length of time. For example, assume an entity issues 100 options to 10 employees that cliff vest at the end of 3 years. If an entity elects to calculate the units-of-service based on annual periods, there are 30 units-of-service (10 employees × 3 years). If the entity elects quarterly or monthly periods, there would be 120 and 360 units-of-service, respectively. Example 2 of the Proposed IFRS addresses how units-of-service should be calculated for equity instruments granted with vesting based on performance conditions (for example, vesting based on increases in market share); it implies that such conditions can be correlated to a defined time period of benefit from which the units-of-service can be calculated.

41. The Proposed IFRS stipulates that the fair value of equity instruments granted be divided by the total units-of-service expected to be received to obtain a deemed fair value per unit-of-service (refer to paragraph 44 of this Invitation to Comment). In order to calculate the total units-of-service expected to be received, an entity must estimate the number of units-of-service that will not be received because of forfeitures. Using the same facts from the example in paragraph 40 of this Invitation to Comment, the total units-of-service that could be received before considering the effect of forfeiture, assuming that units-of-service are based on an annual period, is 30 (10 employees × 3 years). The effect of forfeiture must now be considered. The entity believes that 1 of the 10 employees who received the equity award will leave each year prior to the end of the 3-year vesting period (in other words, 3 employees are expected to terminate their employment prior to vesting in the equity instruments granted). The entity also expects, on average, that each employee will work approximately six months in the year of termination. Therefore, the entity expects to receive 25.5 units of service: 21 units-of-service from the employees who are not expected to terminate (7 employees × 3 years), .5 units-of-service from the employee who terminates in year 1, 1.5 units-of-service from the employee who terminates in year 2, and 2.5 units-of-service from the employee who terminates in year 3. Assuming that the fair value per stock option, after considering the effect of forfeiture, is $6, the deemed fair value per unit-of-service in this example is $235 (1,000 stock options granted × $6 ÷ 25.5 units-of-service expected to be received). Attribution of compensation cost occurs as the entity receives units-of-service (that is, valuable consideration).[46] Appendix B of the Proposed IFRS illustrates the application of the units-of-service method.[47] In addition, Appendix H of this Invitation to Comment provides a comparative analysis of how those illustrations would be different if the provisions of Statement 123 were applied to the same set of facts and circumstances.

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[46]This Invitation to Comments refers to the Proposed IFRS's units-of-service method as an attribution method; however, strictly speaking, attribution is a process of allocating some fixed amount over multiple periods. The units-of-service method is also a measurement method because it assigns a value to each unit-of-service that is based on the expected units-of-service to be received during the vesting period. When units-of-service are received, they are measured upon receipt; however, the deemed value per unit-of-service is based on the grant-date fair value of equity instruments.

[47]Refer to the full discussion of units-of-service method in paragraphs 13–15, B1 and B2 and BC191–BC203, and Example 1 of Appendix B of the Proposed IFRS.

42. As described in paragraph 32 of this Invitation to Comment, the fair value of equity instruments granted and the units-of-service to be received incorporate the effect of forfeiture; therefore, the effect of forfeiture is included both in the numerator and denominator when calculating the deemed fair value per unit-of-service (as illustrated in paragraph 41 of this Invitation to Comment).[48] The IASB concluded that it would be inconsistent to consider the effect of forfeiture in measuring the fair value of equity instruments granted but not consider the effect of forfeiture in measuring the fair value of services expected to be received in return.[49] This approach is based on a presumption that the contract is fairly bargained at grant date. In other words, when an entity determines the terms of the stock-based compensation arrangement, the effect of forfeiture is fully contemplated therein.

43. The units-of-service method of attribution is based on two of the Proposed IFRS's fundamental premises: (a) accounting for the services received in consideration for equity instruments (that is, those events that result in changes in net assets) and (b) the value of equity instruments granted is a surrogate for the value of consideration received. Because the Proposed IFRS is based on accounting for the services received, or changes in net assets, recognized compensation expense is not reversed. In other words, recognized compensation expense is not reversed for forfeitures since (a) forfeiture does not alter the fact that services were received and (b) forfeiture does not result in a change in net assets. By dividing the vesting period into discrete units of time, the units-of-service method allows an entity to measure specific amounts of services received. In addition, the units-of-service method allows an entity to ascribe an exchange value to each discrete unit of service. Since Statement 123 measures compensation equal to the equity instruments actually issued (that is, the total equity instruments awarded less equity instruments forfeited), there is less consequence of incorrectly estimating in advance the amount of services received related to forfeited awards.

44. The units-of-service method requires the calculation of a deemed fair value per unit-of-service. The term *deemed* indicates that the value of the equity instruments has been used to approximate, or as a surrogate for, the value of the services rendered. Once calculated, the deemed fair value per unit-of-service is fixed and does not change. It is not adjusted for forfeitures or any other events that occur subsequent to the measurement date (grant date).[50] This notion is a result of the Proposed IFRS's grant-date fair value measurement of equity instruments that already incorporates the possibility of forfeiture. Once issued, equity instruments are not revalued; to do so would violate the concept that equity is a residual interest that results from changes in net assets. From a conceptual view, each unit-of-service and its deemed fair value represent a unit of valuable

[48]Some argue that including the effect of forfeiture in the numerator and denominator results in double counting the effect of forfeiture. The IASB addressed a similar argument in paragraphs BC198 and BC199 of the Proposed IFRS. The IASB reasoned that employee departures affect both the fair value of the equity instruments granted and the quantity of services received; therefore, the effect of forfeiture should be included in both the numerator and the denominator.

[49]Refer to paragraph BC197 of the Proposed IFRS.

[50]However, if an employee quits prior to vesting date, no more units-of-service are received and, therefore, no more compensation expense is recognized.

consideration given by the service provider in exchange for equity instruments granted by the entity. This is akin to buying stock or other equity instruments, which are issued to an escrow account, with a note that requires regular payments. The stock is issued at grant date at a specified amount for valuable consideration in the form of an obligation to pay the entity at future dates. The value of the stock remains constant from that day forth. In the case of stock options with vesting features, the obligation to pay is conditional. Each unit-of-service rendered is the equivalent of a discrete payment of assets that reduces the balance of the note.

45. Another important effect of fixing the deemed fair value per unit-of-service at grant date is demonstrated when the actual units-of-service received differ from the amount estimated at grant date. For example, suppose an entity issues 1,000 stock options to each of 100 employees, each option cliff-vests at the end of 4 years, and the fair value of each option is worth $5, before adjusting for the possibility of forfeiture. The entity estimates that 40 percent of these options will not vest. The total value of the options expected to vest is $300,000 ($5 × 1,000 × 100 × (100% – 40%)). The entity selects quarters as its length of time for estimating the units-of-service that it will receive, and the entity estimates that forfeitures from employee departures will occur at a constant rate over the four years. The total estimated units-of-service is 1,240.[51] The deemed fair value per unit-of-service is $242 ($300,000 ÷ 1,240). If actual employee departures equal estimated employee departures, the entity will receive 1,240 units-of-service valued at $242 per unit-of-service and will recognize $300,000 of compensation expense over the 4-year vesting period. However, the amount of compensation actually recognized will be affected by the actual units-of-service received by the entity.

46. To demonstrate the impact, two scenarios are proposed using the same base example in paragraph 45 of this Invitation to Comment. Scenario 1 assumes that no employees departed prior to the vesting period; rather, all the equity instruments vested. In that case, the entity would receive 1,600[52] units-of-service at a deemed fair value per unit-of-service of $242; the entity would recognize $387,200 (1,600 × $242) of compensation expense over the 4-year vesting period. Scenario 1 demonstrates how the attribution method can result in an entity (a) recognizing more expense than the fair value, as adjusted for the possibility of forfeiture, of the total options granted, or $300,000,[53] and (b) at the same time, recognizing less expense than the total grant-date fair value, not adjusted for the possibility of forfeiture, of the total options actually

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[51]This is calculated as follows: Of the 100 employees, 60 employees are expected to render service for the full 4 years and satisfy the vesting conditions. To calculate the units-of-service for those employees, 60 employees × 4 years × 4 quarters = 960 units-of-service. Assuming that employee departures occur at a constant rate over the 4-year vesting period: 13 employees depart the first year, 11 in the second, 9 in the third, and 7 in the fourth. Because departures occur ratably, each of those employees is assumed to work 2 full quarters in the year of departure; therefore, the units-of-service for those employees is calculated for the departing employees as follows: for the 13 employees leaving in the first year—13 × 2 quarters; for 11 employees leaving in the second year—11 × 6 quarters; for the 9 employees leaving in the third year—9 × 10 quarters; and for the 7 employees leaving in the fourth year—7 × 14 quarters. The result is 280 units-of-service. The estimated total units-of-service to be received is 1,240 (960 + 280).

[52]This is calculated as follows: 100 employees × 4 years × 4 quarters.

[53]This amount comes from paragraph 45 of this Invitation to Comment.

vested, or $500,000.[54] Scenario 2 assumes that all employees departed prior to the vesting period in a nonratable pattern and that no equity instruments vested. In that case, if the entity actually receives 1,000[55] units-of-service at a deemed fair value per unit-of-service of $242, the entity would recognize $242,000 of compensation expense over the 4-year vesting period. Scenario 2 illustrates how an entity recognizes expense under the Proposed IFRS when no options actually vest.

47. Under the Proposed IFRS's theoretical basis, the outcomes produced in Scenarios 1 and 2 are consistent with its objective of accounting for the services received as consideration for the equity instruments, using a form of grant-date measurement as a practical expedient to achieve this objective. Statement 123 explains the outcomes of Scenarios 1 and 2 as logical extensions of grant-date measurement.[56] Statement 123 does not strictly adopt the conceptual ramifications of grant-date measurement in this regard; rather, it adopts a modified grant-date approach. That is, it permits an entity to adjust recognized compensation expense for the impact of forfeitures during the vesting period, which is a concept borrowed from the vesting-date measurement approach. Under Statement 123, an entity would recognize $500,000 and $0 of compensation expense in Scenarios 1 and 2, respectively, over the 4-year vesting period. Under Statement 123's theoretical basis, the outcomes produced in Scenarios 1 and 2, as calculated in the preceding sentence, are consistent with its explicit notion that issuance occurs when an exchange of all required valuable consideration has taken place (generally, at vesting date).

48. Another consequence of this attribution method is illustrated in the following example. Enterprise C has a policy of issuing stock options with a 4-year service condition to all employees. Typically, college students out on summer break will apply for employment during the summer months. Enterprise C has a long history of employing those students, who generally work for a period of approximately three months, and generally identifies those students for internal record-keeping purposes. Under the Proposed IFRS, implementation guidance for measuring the fair value of equity instruments granted permits an entity to evaluate employee exercise behavior by subgroups if such behavior is relatively homogeneous. Enterprise C's records indicate that over the past decade no student-employee has completed the requisite service period to vest. Enterprise C estimates the fair value of stock options granted to this subgroup at zero (because the forfeitures are expected to be 100 percent). The fair value per equity instrument granted to that group of employees is zero in this case. In this example, the total fair value of the award under Statement 123 and the Proposed IFRS is equal: this is an important result because it suggests that forfeitures can be taken into account by subgroup to produce a total award fair value similar to that obtained under Statement 123. However, if Enterprise C were unable to evaluate the total award by subgroups, it would use a different rate of forfeiture in calculating the grant-date fair value of the award;

[54]This amount comes from the facts in paragraph 45 of this Invitation to Comment: the fair value per option of $5 × 1,000 stock options × 100 employees.

[55]This amount was not calculated. It merely assumes that 1,000 units-of-service were received prior to 100 percent of the company's employees resigning from their positions before the vesting date.

[56]Refer to paragraphs 122 and 123 of Statement 123.

additionally, as a result of using the units-of-service attribution method, units-of-service related to student-employees would be included in the denominator in calculating the deemed fair value per unit-of-service and, hence, ascribed a value.

49. The units-of-service attribution method illustrates the significant conceptual differences in measurement philosophies between the two standards: Statement 123 is based on a modified grant-date approach with issuance occurring at the vesting date (when all required valuable consideration necessary for issuance is deemed to have been received), and the Proposed IFRS uses a grant-date approach as a practical expedient of achieving its accounting objective.

Issue 10: Which of the two attribution methods described by the standards do you believe is more representationally faithful of the economics of stock-based compensation arrangements and why?

Issue 11: Statement 123 does not ascribe value to services received in exchange for equity instruments that are later forfeited (that is, recognized compensation expense is reversed upon forfeiture), whereas the Proposed IFRS ascribes value to such services through its units-of-service attribution method (that is, recognized compensation expense is not reversed upon forfeiture). If you support the Proposed IFRS's view, do you believe the units-of-service method ascribes an appropriate value to services received prior to forfeiture? If so, why? If not, why not?

Performance-Based Awards

Statement 123

50. The attribution method prescribed by Statement 123 for performance awards is based on the premise that compensation cost is attributed to expense over the period in which the employee provides services to earn the related benefit. Generally, this is the period inherent in the performance-based award. Statement 123 indicates that the initial accrual of compensation cost for an award with a performance condition that determines the number of options or shares to be issued will be based on the best estimate of the outcome of the performance condition; this also holds for a performance condition that affects the exercise price or the exercisability date.[57] In addition, Statement 123 states that compensation cost for such an award will be adjusted for changes in the expected or actual outcome of the performance condition until the vesting date. That is consistent with the issuance concept established in the standard: since the equity instruments are not issued, changes in the actual outcome that impact the fair value and quantity of the equity instruments issued should be recognized.

Proposed IFRS

51. The Proposed IFRS makes few references to performance-based awards, although it describes such awards in paragraph 24 of the Proposed IFRS. To fully understand how performance-based awards are accounted for under the Proposed IFRS, it is necessary to

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[57]Refer to paragraphs 26–30 of Statement 123.

examine Example 2 of Appendix B of the Proposed IFRS. Example 2 has been reworked in accordance with Statement 123 and can be found in Appendix H of this Invitation to Comment. It is important to note that the attribution method of the Proposed IFRS decouples the actual outcomes of performance incentives from the service condition. That is, compensation cost is attributed as if the award was service based rather than performance based. That approach is also consistent with the Proposed IFRS's conclusion that the possibility of forfeiture affects the value of the equity instruments granted and, therefore, should be taken into account when measuring the fair value of those instruments. Consequently, compensation cost is recorded regardless of the actual outcome. Paragraphs 52–60 of this Invitation to Comment provide three examples to illustrate how the attribution model functions with respect to performance-based awards. Example 1 demonstrates how to account for a bonus payable in stock, Example 2 demonstrates how to account for an option award under which the number of options to be earned varies, and Example 3 demonstrates how to account for an option award under which the exercise price varies.

Example 1

52. Entity Z gives notice to all employees on January 1, 2002, that it will pay them a bonus in Entity Z stock equal to 10 percent of their respective annual salaries if sales for 2002 increase by 10 percent over the prior year. The potential total bonus is $2,000,000 (10 percent of the total of all respective annual salaries) and its fair value is $1,500,000, after adjusting for the probability of not reaching the target sales level and the timing of payment. Entity Z expects to receive 400 units-of-service during 2002. Under the Proposed IFRS, Entity Z recognizes $1,500,000 of compensation expense during 2002 if the 400 units-of-service are received. If it was deemed probable that the bonus would be paid, Statement 123 would require the recognition of $2,000,000 during 2002. During December 2002, Entity Z determines that sales for the year will not increase by 10 percent; therefore, the bonus will not be paid. Under Statement 123, the cumulative compensation expense is reversed. Under the Proposed IFRS, no compensation expense is reversed. Likewise, if the sales level was achieved, no compensation expense beyond $1,500,000 would be recognized under the Proposed IFRS.

Example 2

53. This example is the same fact pattern presented in Illustration 2(a) of Statement 123.[58] On January 1, 2000, Company X agrees to issue stock options to 1,000 employees based on the following conditions: if the employee is still employed at the end of December 31, 2002, Company X will issue 100 options if market share increases by 5 percent, 200 options if market share increases by 10 percent, or 300 options if market share increases by greater than 20 percent.

54. At grant date, each option is valued using an option-pricing model of $17.15, which does not include the effect of possible forfeitures. Company X recalculates the fair value at grant date incorporating the effects of forfeiture for employee terminations, which

[58]Refer to paragraphs 306–308 of Statement 123.

results in a fair value of $15.65 per option. Company X weights the possible outcomes to determine the fair value of the total award: it determines there is a 30, 55, and 15 percent[59] likelihood that market share will increase by 5, 10, and greater than 20 percent, respectively.[60] Based on its calculations, the fair value of the award is $2,895,250.[61] The estimated units-of-service to be received over the vesting period is 2,867. The deemed fair value per unit-of-service is $1,010.

55. During 2000, 2001, and 2002, Company X receives actual units-of-service of 975, 922, and 862, respectively (totaling 2,759). Hence, Company X recognizes compensation expense of $984,750, $931,220, and $870,620, during 2000, 2001, and 2002, respectively. The total compensation cost recognized is $2,786,590, which is less than the estimated value at the grant date because Company X received less units-of-service than expected (2,759 received as opposed to 2,867 expected).

56. Under Statement 123, Company X recognizes compensation expense of $1,043,863, $856,357, and $2,375,275, in 2000, 2001, and 2002, respectively, totaling $4,275,495.[62] The main difference in the compensation expense recognized under the two standards is that compensation cost under the Proposed IFRS is not changed to reflect the actual outcome of the performance award. In this example, Company X's market share was greater than 20 percent, which resulted in the issuance of 300 options per employee. Statement 123 recognizes the effect of actual outcomes of performance awards, whereas the Proposed IFRS does not recognize that effect.

Example 3

57. This example is the same fact pattern presented in Illustration 2(b) of Statement 123.[63] On January 1, 2000, Company T agrees to issue 10,000 stock options to its chief executive officer (CEO) under the following conditions: if the employee is still employed at the end of December 31, 2001, Company T will reduce the exercise price of each option from $50 to $30 if market share increases by 10 percent.

58. At grant date, each option is valued using an option-pricing model at $15.87 based on an exercise price of $50 and $22.64 based on an exercise price of $30. This does not include the effect of forfeiture for termination of employment, which must be considered

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[59]These probabilities total 100 percent. For purposes of this example, no weight was assigned to the probability that sales would increase by less than 5 percent or decrease during the vesting period. Any weight assigned to these possibilities would reduce the fair value of the award.

[60]The Proposed IFRS uses weighting in determining the fair value of a performance-based arrangement in Example 2 of Appendix B. The FASB staff understands that simply using the fair value of the most likely outcome would not be in accordance with the Proposed IFRS unless there was a 100 percent probability that it would be achieved.

[61]This is obtained by adding the total of the weighted expected outcomes: expected outcome 1 is $469,500 ($15.65 × 100 options × 1,000 employees × 30 percent), expected outcome 2 is $1,721,500 ($15.65 × 200 options × 1,000 employees × 55 percent), and expected outcome 3 is $704,250 ($15.65 × 300 options × 1,000 employees × 15 percent).

[62]Refer to paragraphs 306–308 of Statement 123 for details on how these amounts are calculated.

[63]Refer to paragraphs 309 and 310 of Statement 123.

in measuring the fair value of equity instruments under the Proposed IFRS. In accordance with the Proposed IFRS, Company T reduces the value of the options by 5 percent because it determines there is a 5 percent probability that the CEO will terminate prior to the vesting period: the estimated value of the options is now \$15.08 and \$21.51, respectively. Company T weights the possible outcomes to determine the fair value of the total award: it determines there is a 30 percent probability that market share will increase by less than 10 percent, and a 70 percent probability that it will increase by more than 10 percent.[64] Based on its calculations, the fair value of the award is \$195,810.[65] The estimated units-of-service, based on annual periods, to be received over the vesting period is two. The deemed fair value per unit-of-service is \$97,905.

59. During 2000 and 2001, Company T receives one unit of service (cumulative total of two). Hence, Company T recognizes compensation expense of \$97,905 and \$97,905 during 2000 and 2001, respectively. The total compensation cost recognized is \$195,810, regardless of the actual outcome of the performance condition.

60. Under Statement 123, if the performance condition is expected to be, and is, satisfied, Company T recognizes compensation expense of \$113,200 and \$113,200 in 2000 and 2001, respectively, totaling \$226,400.[66] If the performance condition is not satisfied, Company T recognizes compensation expense of \$113,200 (because it assumes the performance would be satisfied, as that is the most likely outcome at the end of 2000) and \$45,500 in 2000 and 2001, respectively, totaling \$158,700. In comparing the two standards, the use of fair value weighted for the expected probabilities of outcomes causes a portion of the difference, and the decoupling of the actual outcome of the performance condition from the award causes the rest of the difference. It is important to note that adjusting compensation expense for actual outcomes stems from Statement 123's modified grant-date measurement method.

Issue 12: Do you believe that the actual outcome of performance awards should affect the total compensation expense incurred by an enterprise? If so, why? If not, why not?

Measurement Philosophy and Attribution of Compensation Cost

61. Both Statement 123 and the Proposed IFRS require that option-pricing models be used to measure the fair value of a stock option at grant date. The standards also specify that the expected option life must be estimated and used to measure the stock option's fair value; therefore, the fair value of a stock option at grant date captures the time value of the option over the expected option life. In most instances, the expected option life exceeds the vesting period, and it can never be shorter than the vesting period (that is,

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[64]The Proposed IFRS uses weighting in determining the fair value of a performance-based arrangement. The FASB staff understands that simply using the fair value of the most likely outcome would not be in accordance with the Proposed IFRS unless there was a 100 percent probability that it would be achieved.

[65]This is obtained by adding the total of the weighted expected outcomes: expected outcome 1 is \$45,240 (\$15.08 × 10,000 options × 30 percent) and expected outcome 2 is \$150,570 (\$21.51 × 10,000 options × 70 percent).

[66]Refer to paragraphs 309 and 310 of Statement 123 for details on how these amounts are calculated.

employees are not entitled to any benefits from the option until the option is vested). Whenever the expected option life exceeds the vesting period, a portion of an option's time value is related to employment service during this period because employee options generally can be exercised for only a short period (usually 90 days) after termination of service.

62. For instance, Enterprise B issues a stock option that cliff vests after three years of service to an employee. Historical evidence indicates that on average, employees exercise vested options two years after the vesting date; thus, the expected option life is five years. Enterprise B pays no dividends on its stock, estimates expected volatility on the underlying stock as 40 percent, and notes a risk-free interest rate of 4 percent on U.S. zero-coupon treasury securities with similar maturities. Enterprise B uses the Black-Scholes option-pricing model to determine the fair value of the option, which is $12.31. But the fair value of the same option at grant date is different if the expected life is equal to the vesting period of three years. Assuming all factors other than expected life remain the same (which they should not because volatility and the risk-free interest rates have term structures), the fair value of the same option at grant date would be $9.45, a difference of $2.86 or 23 percent, which represents the change in time value of the option from using a shorter option life.

Statement 123

63. Because Statement 123 requires that the $12.31 be attributed over the vesting period of 3 years (assuming the option vests), some argue that Enterprise B has overstated its cumulative expense over the vesting period by $2.86. The corollary is that Enterprise B should attribute expense over the expected option life. The Board noted some conceptual appeal to this argument but did not find it compelling enough to change its conclusion that compensation cost should be attributed over the vesting period.[67]

Proposed IFRS

64. The Proposed IFRS uses the fair value of the option at grant date to obtain a surrogate measure for the value of the services received. The units-of-service method ascribes that surrogate value to each discrete unit of service that is received by the entity over the vesting period. In the case of Enterprise B, some argue similarly that the deemed fair value per unit-of-service is overstated by 23 percent if it is not based on the total units-of-service that will be received over the expected option life. Because the basic principle underlying the Proposed IFRS is to value each unit-of-service received (as opposed to each option, in accordance with Statement 123), valuing units-of-service received beyond the vesting period is more important than in Statement 123. The IASB acknowledged the argument described in paragraph 63 of this Invitation to Comment in the Proposed IFRS's basis for conclusions, but it concluded that a vesting requirement to provide services over a specified period is "the best evidence of when the employees

[67]Refer to paragraphs 197–199 of Statement 123.

render services in return for the shares or options."[68] This is consistent with the FASB's conclusion (refer to paragraph 63 of this Invitation to Comment).

Issue 13: Do you believe that this issue is important in considering an attribution model's validity? If so, why? If not, why not?

Attribution of Compensation Cost—Transactions with Nonemployees

65. In transactions in which the fair value of goods or services received is more reliably measurable (or readily determinable, under the Proposed IFRS), Statement 123 and the Proposed IFRS appear similar. For instance, if a company acquires, in exchange for stock options, a truck for which there is a ready market value, both Statement 123 and the Proposed IFRS require that the truck be recorded as an asset at its fair value. However, there are important differences when the fair value of the equity instruments is used to measure the value of goods and services received.

Statement 123

66. Statement 123 stipulates that all transactions in which goods and services are exchanged for the issuance of equity instruments should be recognized at fair value. Under Issue 96-18, if the value of the equity instruments granted is more reliably measurable, then they are measured at fair value on the earlier of the performance-commitment date or the performance-completion date (refer to paragraphs 23–29 of this Invitation to Comment). Issue 96-18 states that the fair value of equity instruments granted should be recognized in the same period and in the same manner as if the enterprise had paid cash for the goods or services received.[69] Issue 96-18 provides detailed guidance for accounting for equity instruments granted to nonemployees at, prior to, and subsequent to measurement date when the terms and conditions are known up front and when they are not known up front.[70]

Proposed IFRS

67. The IASB made no distinction between employee and nonemployee transactions; therefore, the differences described in the section on attribution of compensation cost for employee transactions apply equally to nonemployee transactions. Paragraphs 68–74 of this Invitation to Comment use several examples that illustrate the differences in accounting that might result under Issue 96-18 and the Proposed IFRS when the fair value of the equity instruments is used to measure the value of goods and services received.

Transactions for Goods Received

68. In transactions with nonemployees that result in the delivery of goods for which the fair value is not readily determinable, equity instruments are measured at fair value at the

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[68]Refer to paragraphs BC192 and BC193 of the Proposed IFRS.

[69]Refer to Issue 2 of Issue 96-18.

[70]Refer to Issues 3 and 4 of Issue 96-18.

grant date under the Proposed IFRS. Example 1 demonstrates this basic notion and Example 2 provides further insight.

Example 1

69. An entity contracts with a manufacturer to make a custom-designed piece of equipment for a specialized industry in exchange for stock options. There is no market for this specialty equipment; the entity determines that the fair value of the equity instruments is more readily determinable than the fair value of the equipment. All of the terms and conditions are known when the contract is signed. The grant-date fair value of the stock options, before considering the possibility of forfeiture, is $500,000. The entity estimates that the likelihood of forfeiture for nonperformance under the contract is 5 percent; therefore, it estimates that the grant-date fair value of the stock options, after considering the possibility of forfeiture, is $475,000. The entity recognizes an asset of $475,000 when the equipment is received, regardless of whether the fair value of the stock options is $750,000 or $300,000 at that date. If the performance-commitment date is the same as the grant date because there is a significantly large disincentive for nonperformance (for example, a significant monetary penalty), the entity will record an asset of $500,000 under Issue 96-18 versus an asset of $475,000 under the Proposed IFRS. The difference stems from the way the possibility of forfeiture is treated: under Issue 96-18, the possibility of forfeiture does not impact the fair value of equity instruments at the date of issuance, as defined by Statement 123, whereas under the Proposed IFRS, the possibility of forfeiture impacts the fair value of equity instruments at grant date. Under Issue 96-18, assuming the measurement date is the performance-completion date (when the equipment is received), the entity would record the asset at the fair value of the stock options at that later date ($750,000 or $300,000). Notwithstanding the difference that results from different measurement dates, the two standards both recognize the cost when the goods are received.

Example 2

70. An entity contracts with a manufacturer to make a custom-designed piece of equipment for a specialized industry and agrees to pay for it by issuing 20,000 stock options. Since there is no market for this equipment, the entity determines that the fair value of the equity instruments is more readily determinable than the fair value of the equipment. All of the terms and conditions are known when the contract is signed except that the actual quantity of stock options awarded can change: the entity has agreed to issue 25,000 options if it receives the equipment by an accelerated delivery date. The grant-date fair value of 20,000 and 25,000 options, before considering the possibility of forfeiture, is assumed to be $500,000 and $625,000, respectively. Paragraphs 71 and 72 of this Invitation to Comment illustrate two scenarios that could occur under Issue 96-18: scenario 1 assumes the performance-commitment date is the same as the grant date because there is a significantly large disincentive for nonperformance, and scenario 2 assumes the measurement date is the performance-completion date. In scenario 1, the entity estimates that the likelihood of forfeiture for nonperformance under the contract is 5 percent because of the significantly large disincentive for nonperformance; therefore, it estimates that the grant-date fair value of 20,000 and 25,000 options, after considering the

possibility of forfeiture, is $475,000 and $593,750, respectively. In scenario 2, the entity estimates that the likelihood of forfeiture for nonperformance under the contract is 15 percent (the likelihood of forfeiture is greater in scenario 2 because there is not a significantly large disincentive for nonperformance); therefore, it estimates that the grant-date fair value of 20,000 and 25,000 options, after considering the possibility of forfeiture, is $425,000 and $531,250, respectively. Under the Proposed IFRS, an entity would weight the probable outcomes to determine the fair value of the award.[71] In scenarios 1 and 2, assuming the entity weights each outcome at 50 percent, the fair value of the award would be measured at $534,375 and $478,125, respectively, for the award. Under scenarios 1 and 2 the entity would recognize an asset of $534,375 and $478,125 when it is received, regardless of when the manufacturer delivers the equipment.

71. As noted previously, scenario 1 assumes the performance-commitment date is the same as the grant date because there is a significantly large disincentive for nonperformance. In that case, under Issue 96-18, the entity should record the lowest of the possible fair values, before considering the possibility of forfeitures, associated with each outcome; this is $500,000. However, the entity must also adjust the value for the actual outcome. If the manufacturer does not meet the accelerated delivery date, then no adjustment is necessary, and the entity recognizes an asset of $500,000 when it is received. If the manufacturer meets the accelerated delivery date, then the entity must adjust the value for the actual outcome by (a) calculating the then-current fair value of the revised instruments utilizing the then-known quantity or term and (b) the then-current fair value of the old equity instruments immediately before the quantity or term becomes known.[72] Assuming the then-current fair value of 25,000 stock options is $937,500 and the then-current fair value of the old equity instruments immediately before the quantity or term becomes known is $750,000, the entity would recognize an asset of $687,500 ($500,000 + $187,500, which is $937,500 – $750,000).

72. As noted previously, scenario 2 assumes the measurement date is the performance-completion date. In scenario 2, the entity will measure the fair value of the options on the date the asset is received. If the manufacturer does not meet the accelerated delivery date, the purchaser recognizes an asset at the then-current fair value of 20,000 options (assumed to be $825,000 on the delivery date). If the manufacturer meets the accelerated delivery date, the entity will recognize an asset of $937,500. These outcomes illustrate the significant difference posed by different measurement dates when juxtaposed to the value of the equipment that would be recognized under the Proposed IFRS ($534,375 in scenario 1 and $478,125 in scenario 2). Once again, under Issue 96-18 and the Proposed IFRS, the entity recognizes the asset when it is received.

73. The second scenario provides additional insight into the theory underlying Issue 96-18. While a binding contract has been signed, there is no significant disincentive for nonperformance. A manufacturer might choose to sell the equipment to someone else, or

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[71]The Proposed IFRS uses weighting in determining the fair value of a performance-based arrangement. The FASB staff understands that simply using the fair value of the most likely outcome would not be in accordance with the Proposed IFRS unless there was a 100 percent probability that it would be achieved.

[72]Refer to Issue 4(c) of Issue 96-18.

not deliver the equipment, if it deemed the fair value of the stock options to be insufficient revenue.[73] In other words, no exchange of valuable consideration has occurred until the equipment is delivered. It should be noted that no amount would be recognized in the financial statements under Issue 96-18 or the Proposed IFRS, if the equipment was not delivered. On a further note, in accordance with U.S. GAAP, the manufacturer's revenue recognition would be based on the fair value of the options on the delivery date.

74. The first scenario illustrates the outcome of modification accounting, which is rooted in paragraph 35 of Statement 123, when the actual outcome of a performance condition affects the cost recognized. The Proposed IFRS does not have a similar concept. Once again, the majority of difference noted in Example 2 stems from the different measurement dates used to value the equity instruments.

Issue 14: Do you believe that the measurement-date criteria in Issue 96-18 accurately reflect the economics of transactions with nonemployees? If not, why not?

Certain Transactions for Goods Received

75. While this section addresses the different measurement dates used by the standards when the fair value of the equity instruments granted is more reliably measurable (or readily determinable) than the fair value of the goods received, there may be certain instances in which the accounting under U.S. GAAP differs from the Proposed IFRS when the fair value of the goods or services received is more reliably measurable (or readily determinable) than the fair value of the equity instruments granted. The following example, using simplified assumptions, illustrates this observation. Company Z is publicly traded and manufactures certain products that contain gold. Company Z enters into a contract to purchase a fixed quantity of gold 90 days hence at gold's 90-day forward price. The contract provides Company Z with 2 settlement alternatives: it can either deliver a fixed number of shares of its common stock (100 shares in this case) or deliver cash equal to the settlement-date fair value of the fixed number of shares of its common stock. The total value of the gold to be purchased is $8,000, which is equal to the total value of 100 shares of Company Z's common stock, on the day Company Z enters into the contract. Ninety days from entering into the contract, the fair value of the gold is $6,000, and the fair value of 100 shares of Company Z's common stock is $8,100. Company Z takes delivery of the gold for cash equal to the fair value of 100 shares of Company Z's common stock on the settlement date ($8,100).

76. Under U.S. GAAP, the contract would be accounted for as a derivative instrument in accordance with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities;* therefore, at settlement date, Company Z would have previously recognized a liability for derivative on the balance sheet and recorded an unrealized loss in the income statement of $2,100 during the 90-day period. In accordance with

[73]Presumably, the manufacturer would be subject to some economic penalty for its nonperformance in that case. At the very least, it might be sued for damages.

Statement 133, upon settlement, Company Z would debit inventory for $6,000 to recognize delivery of the gold, debit liability for derivative for $2,100 to settle the derivative contract, and credit cash for $8,100 to recognize the payment to the counterparty.

77. This contract would be accounted for as a share-based payment transaction with a cash-settlement alternative subject to the Proposed IFRS. Under the Proposed IFRS, no accounting for this contract would take place prior to delivery of the gold on the settlement date. Upon settlement, Company Z would debit inventory for $6,000 to recognize delivery of the gold, debit equity for $2,100 to recognize the deemed repurchase of an equity interest, and credit cash for $8,100 to recognize the payment to the counterparty. This is a significantly different accounting outcome than that prescribed by Statement 133.

Transactions for Services Received

78. The accounting for the transactions with nonemployees for services are similar in most respects to those transactions with employees described in paragraphs 39–60 of this Invitation to Comment. For that reason, no further comment is offered here on the Proposed IFRS's conceptual basis for those transactions. Generally, the difference in measurement date will result in different fair values being used under both standards. The per-option fair values will be different because the Proposed IFRS adjusts for the possibility of forfeiture. No compensation cost will be recognized for equity instruments that are forfeited under Statement 123. Compensation cost will be attributed in different patterns throughout the vesting period under Issue 96-18 and the Proposed IFRS. Performance-based awards are valued differently under the Proposed IFRS because their value is decoupled from the actual performance outcome. Those differences have been sufficiently illustrated in other sections of this Invitation to Comment.

Income Taxes

79. Statement 123 requires that (a) when realized tax benefits from equity awards exceed the recorded tax benefits based on the cumulative amount of stock-based compensation expense recognized, the difference is directly credited to additional paid-in capital, and (b) when realized tax benefits from equity awards are less than the recorded tax benefits based on the cumulative amount of stock-based compensation expense recognized, the difference (that is, the excess deferred tax asset) is written off to the income statement to the extent that it cannot be offset by excess tax benefits previously recorded in additional paid-in capital from other equity awards. The Board stated that this is the preferable approach based on the following: (a) this method is less complex to apply than a method based on changing intrinsic values, (b) this method produces less income statement volatility, and (c) it is consistent with the tax treatment of equity awards accounted for under Opinion 25, which asserts that such tax benefits represent additional proceeds from the issuance of stock and therefore, represent equity.[74]

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[74]Refer to paragraphs 41–44 and 222–231 of Statement 123.

80. The Proposed IFRS requires that all tax effects related to equity instruments granted be recognized in the income statement. The IASB concluded that issuing equity instruments in exchange for services received generates compensation expense, an income statement element; consequently, tax benefits received relate to an income statement item, not an equity item.[75] One consequence of this approach is that an IFRS-reporting entity's deferred tax asset and deferred tax expense for stock-based compensation will fluctuate at each reporting date based on changes in the entity's stock price (if the tax jurisdiction provides tax benefits based on the intrinsic value of the award, such as in the United States). In addition, this approach might result in an entity recognizing income in excess of the cumulative compensation expense. For example, Company A has a 35 percent effective tax rate; it recognizes $1,000,000 in cumulative pretax compensation expense over the 3-year service period prior to vesting for 200,000 stock options issued to certain officers based on an exercise price of $10. Five years after the grant date and 2 years after the award is accounted for as compensation, the per-share market price of Company A stock is $60, and stock-option holders exercise 100,000 stock options, which results in tax benefits of $1,750,000 (($60 – $10) × 100,000 × 35%) to Company A (assuming the options exercised were not incentive stock options under the U.S. tax code). Under Statement 123, $1,575,000[76] of the tax benefit is credited directly to equity, whereas under the Proposed IFRS, $1,750,000 of the tax benefit is credited to the income statement. Hence, in the example, the cumulative after-tax effect from the issuance of stock options results in income. This difference is perhaps the most significant between the two standards.

81. FASB Statement No. 109, *Accounting for Income Taxes,* states, "The Board believes that the tax consequences of an event that increases or decreases contributed capital should be allocated directly to contributed capital" (paragraph 143). The Board also believes that it would not be appropriate to recognize a tax benefit from the exercise of employee stock options in the income statement because the difference between the exercise price of the stock options and the exercise-date fair value of the stock is not reflected in the income statement. When equity instruments are awarded to an employee under Statement 123, the entity recognizes compensation expense equal to the grant-date fair value of the equity award over the vesting period. The compensation expense based on the grant-date fair value of the equity award is the purchase price the employee pays in services for the equity instruments awarded. When the equity instruments vest, they are issued, as defined in Statement 123, to the employee. On issuance, the employee is deemed to hold issued equity instruments and, therefore, is deemed to be an equity interest holder. In the case of stock options, the equity interest holder becomes a shareholder by exercising those options and paying the exercise price to the issuing entity. This results in the issuance of stock by the issuing entity. In return for granting stock options, the issuing entity receives services from an employee, which represent assets that should be expensed when consumed. Upon issuance, the employee becomes an equity interest holder; thus, there is a significant difference in the standing of the employee. Upon exercise, the issuing entity receives cash from an equity interest holder

[75] Refer to paragraphs BC295–BC305 and E5 of Appendix E of the Proposed IFRS.

[76] ({[($60 – $10) × 100,000] – [$1,000,000 × (100,000 ÷ 200,000)]} × 35%).

to convert one form of equity interest to another. The last event is between the issuing entity and an equity interest holder, but may result in excess tax benefits received from the taxing authority. As a result, excess tax benefits received from this last event represent tax consequences that should be allocated directly to contributed capital.

82. It should be noted that IAS 12 (revised 2000), *Income Taxes,* requires that certain tax effects be credited or charged directly to equity, including certain tax effects related to the initial recognition of the equity component of a compound financial instrument. Some argue that the tax treatment accorded by Statement 123 and Statement 109 is consistent with IAS 12. The Proposed IFRS acknowledges, but counters, the argument that recognizing excess tax benefits directly in equity is consistent with IAS 12 and the argument in paragraph 81 of this Invitation to Comment that the excess tax benefits result from an equity transaction. It notes that the tax deduction stems from compensation expense and, therefore, should be recognized in the income statement. Additionally, it notes that recognizing tax benefits in the income statement is consistent with the IASB conceptual framework "because reporting amounts directly in equity would be inappropriate, given that the government is not an owner of the entity."[77] In other words, since the government (or taxing authority) is conveying economic benefits through a tax deduction and it is not an equity interest holder of the enterprise (nor will it become an equity interest holder), those tax benefits should not be recognized directly in equity. Standing Interpretations Committee (SIC) Interpretation 17, *Equity—Costs of an Equity Transaction,* specifies that incremental external costs directly attributable to the equity transaction should be charged directly to equity. Such costs may include costs paid to attorneys, bankers, and accountants (who may be similar to the taxing authority in that they are not equity interest holders). Some argue that the rationale supporting the IASB's conclusion with respect to the taxing authority in the Proposed IFRS is incongruous with the conclusions of SIC Interpretation 17.

Issue 15: Do you believe that all of the tax benefits derived from stock-based compensation arrangements should be recognized in the income statement? If so, why? If not, why not?

DISCLOSURE

83. Generally, the Proposed IFRS incorporates the financial reporting disclosures required under Statement 123 and requires additional disclosures including the following:[78]

- For stock options granted during the period, an explanation of any difference between historical volatility and expected volatility used to determine the fair value of equity instruments granted
- For stock options granted during the period, assumptions made with regard to vesting conditions and an explanation of how vesting conditions have been taken into account

[77] Refer to paragraph BC303 of the Proposed IFRS.

[78] Refer to paragraphs 45–48 and 243–261 of Statement 123 and paragraphs 45–53 of the Proposed IFRS.

in measuring fair value, including the resulting impact on the fair value measure (refer to paragraphs 31–37 of this Invitation to Comment)

- For options, shares, or other equity instruments that vested during the period, or would have vested during the period had the vesting conditions been satisfied, a comparison of the percentage of equity instruments that vested and the grant-date estimate of the percentage or number of equity instruments expected to vest
- For options that were exercised during the period, a comparison of actual option life and the grant-date estimate of expected option life.

Several of those additional requirements are designed to provide further information on how estimates are established for the valuation of equity instruments granted and to provide information on how actual amounts differed from the original estimates. Generally, an IFRS-reporting entity will provide more information with respect to the valuation of equity instruments granted than an entity reporting under Statement 123.

84. Some have suggested that disclosures for stock-based compensation arrangements should be expanded. Users who focus on cash flows in estimating enterprise value have suggested that information about the cash flow effects of stock options is important. Suggested disclosures would note (a) the direct cash flow effects from option exercise including cash proceeds received upon exercise and cash proceeds from excess tax benefits[79] and (b) indirect cash flow effects from option exercise including cash which could have been received through a direct sale of shares versus the cash received from the exercise price, cash proceeds from the sale of written put options, and cash payments for share repurchases related to stock option exercises.

85. Others have suggested that information about the dilutive effect of options exercised during the current period or the potential dilution to current shareholders from potential option exercises would also be useful information. Examples of additional disclosures with respect to dilution include (a) the aggregate exercise-date intrinsic value of options exercised during each period, (b) the aggregate intrinsic value of outstanding, in-the-money options at each balance sheet date (the "option overhang"), (c) a tabular or graphic presentation of the outstanding option pool illustrating the relationship between share prices and the number of in-the-money options, and (d) a tabular or graphic presentation of the outstanding option pool illustrating the number of exercisable ("vested") options over time for future periods.

86. Some believe that disclosures for stock options could be improved by providing a sensitivity analysis in the footnotes to the financial statements that shows the effect on an enterprise's net income and earning per share of changes in volatility assumptions used in the option-pricing model at the grant date.

Issue 16: As discussed in paragraph 83 of this Invitation to Comment, the Proposed IFRS expands on the disclosure requirements in Statement 123. Do you believe that those expanded disclosures would be more informative to users of financial

[79]Refer to paragraph 44 of Statement 123.

statements? If so, why? If not, why not? (Which of the disclosure requirements should be eliminated or modified in that case?)

Issue 17: Please describe any additional disclosures that you believe should be required in order to inform a user of financial statements about the economics of stock-based compensation arrangements.

TRANSITION

87. No similarities or differences were classified as primary in this section. Secondary items are described in Appendix A of this Invitation to Comment.

CONCLUSION

88. Based on this analysis, the FASB staff observed the following:

- Neither Statement 123 nor the Proposed IFRS were intended to follow a pure grant-date measurement method.
- The most important differences between the two standards, excepting the major difference associated with Statement 123's permitting the continued use of the intrinsic value method under Opinion 25 for stock-based employee compensation, stem from (a) a philosophical difference that affects how forfeitures are accounted for, (b) the units-of-service attribution method that results in different compensation expense recognition patterns and total compensation expense than under Statement 123, (c) a difference in accounting for income taxes, and (d) different measurement-date methodologies for nonemployee transactions when the fair value of equity instruments granted is more reliably measurable.
- Statement 123 and the Proposed IFRS are substantively different, even though they are both based on the principle of measuring goods or services at fair value when received.

89. This Invitation to Comment was designed to encourage and facilitate a full analysis of the IASB's Proposed IFRS by the FASB's constituents. Such analysis is important because of the FASB's objective of promoting international convergence of high-quality international accounting standards. Comments received in response to this Invitation to Comment will be used by the FASB to determine whether changes should be proposed to U.S. accounting standards for stock-based compensation to improve financial accounting and reporting standards.

APPENDIX A: SECONDARY SIMILARITIES AND DIFFERENCES

CONTENTS

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INTRODUCTION

A1. Appendix A discusses the secondary similarities of and differences between Statement 123 and the Proposed IFRS identified as a result of an examination of the Proposed IFRS (refer to paragraphs 10–12 of this Invitation to Comment). As noted in paragraph 12, secondary items are categorized by scope, recognition, measurement, disclosure, and transition.

SCOPE

A2. Both standards have similar scopes:

- They apply to "all transactions in which an entity acquires goods or services by issuing equity instruments or by incurring liabilities to the supplier in amounts based on the price of the entity's common stock or other equity instruments."[1]
- They apply to transactions with employees and nonemployees.
- They apply to transactions in which equity instruments are granted to employees by an entity's shareholders unless the transfer is clearly for a purpose other than compensation.

There is one secondary difference relating to scope.

Transactions with Certain Stockholders

A3. If a principal stockholder[2] grants equity instruments of the entity to an employee, the equity instruments should be accounted for as stock-based compensation by the entity in accordance with Statement 123, unless the transfer clearly is for a purpose other than compensation. The Board states that the substance of such a transaction is representative of a capital contribution by the owner to the entity and the entity subsequently awarding equity instruments to its employee.[3] The Proposed IFRS establishes similar guidance, except it applies to such transactions by all stockholders, not just principal stockholders. Essentially, the IASB agreed with the FASB's rationale and extended it to all stockholders.[4] Statement 123 does not address whether the FASB considered application to all stockholders, and the Proposed IFRS does not address whether the IASB considered application solely to principal stockholders (although the FASB staff understands that this issue was deliberated by the IASB).

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[1]Refer to paragraph 6 of Statement 123 and paragraphs 1–3 of the Proposed IFRS.

[2]One who either owns 10 percent or more of an entity's common stock or has the ability, directly or indirectly, to control or significantly influence the entity. Refer to the comparative glossary in Appendix I.

[3]Refer to paragraph 15 of Statement 123.

[4]Refer to paragraphs 3 and BC16–BC19 of the Proposed IFRS.

Issue A1: Statement 123 distinguishes between a principal stockholder and a stockholder for certain transactions, and the Proposed IFRS does not. Which view do you support and why?

RECOGNITION

A4. Statement 123 is built on the following premises:[5]

a. Employee stock options have value.
b. Valuable financial instruments given to employees give rise to compensation cost that is properly included in measuring an entity's net income.
c. The value of employee stock options can be estimated within acceptable limits for recognition in financial statements.

A5. The IASB based the Proposed IFRS on similar premises:[6]

a. Economic resources[7] in the form of goods and services are received by the entity as consideration for the issuance of stock, stock options, or other equity instruments.
b. Inflows of economic resources and corresponding increases in equity should be accounted for in the financial statements.
c. An expense is recognized upon the consumption of those economic resources.

A6. While the rationale for Statement 123 and the Proposed IFRS are worded differently, the result is that both standards require the recognition of compensation expense measured at the grant-date fair value of the equity instruments granted to employees. The Invitation to Comment does not summarize all the arguments for and against the recognition of compensation expense relating to the grant of equity instruments. The arguments for and against are fully discussed in the respective basis for conclusions of each standard.[8]

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[5]Paragraphs 75–117 of Statement 123 discuss the rationale for these premises and the Board's conclusions on the associated recognition issues.

[6]Paragraphs BC25–BC55 include a full discussion of these premises and the IASB's conclusions on the associated recognition issues.

[7]The term *economic resources* implies that something has value.

[8]Refer to paragraphs 135–154 of Statement 123 and paragraphs BC64–BC81 of the Proposed IFRS.

MEASUREMENT

Similarities

Fair Value

A7. One of the important similarities of the two standards is the requirement to measure at fair value the value of equity instruments issued to employees and nonemployees (in the case of nonemployees, only if the presumption is rebutted—refer to paragraph A10 of this Invitation to Comment). The concept of fair value is also similar in both standards: essentially, it is the amount at which an exchange could take place between willing parties in an arm's-length transaction, other than in a forced or liquidation sale.[9] The standards have similar fair value hierarchies. Quoted market prices in active markets for equity instruments with similar terms and conditions are the best indicators of fair value. If market prices do not exist, then the fair value is based on an estimate using the best information available in the circumstances. The Boards concluded that the components of fair value of a stock option are intrinsic and time values: that value is implicit in the negotiated bargain between the issuing entity and the employee or nonemployee. Each basis for conclusions fully discusses why it was concluded that fair value should be used to measure the value of equity instruments granted.[10]

Measurement Date

A8. Both Statement 123 and the Proposed IFRS require that equity instruments granted to employees be measured at grant date. Many have argued that other dates should be used to measure the fair value of the equity instruments; those other dates include the service expiration date, the vesting date, and the exercise date. The Boards agreed on the grant date based on similar rationales. The FASB concluded that measurement at the grant date bases the compensation cost stemming from a stock-based compensation award on the stock price at the date the parties agree to its terms. The IASB concluded that measurement at the grant date is appropriate because it does not require remeasurement of the equity instruments and it provides a reasonable surrogate measure of the fair value of employee services received. The premise underlying the IASB conclusion is that the terms at the grant date form the basis of fairly bargained negotiations between the issuer and the counterparty; therefore, those terms embody the full value of the stock-based compensation arrangement. Essentially, the Boards concluded that any other measurement date effectively bases compensation cost on changes in the value of equity instruments, thereby artificially inflating or reducing compensation cost associated with the equity instruments. This point can also be stated differently: by definition, equity is a residual interest (that is, assets minus liabilities equals equity), or, rather, changes in net assets drive changes in equity, not vice versa. In addition, subsequent changes in the stock price would not form a part of the fairly

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[9]Refer to the comparative glossary in Appendix I for definitions of fair value.

[10]Refer to paragraphs 134–154 of Statement 123 and paragraphs BC56–BC81 of the Proposed IFRS.

bargained negotiations, although the possibility of a stock price's increase would be included as part of those negotiations (for example, time value of an option). The bases for conclusions provide further discussion on why the Boards concluded as they did.[11]

Tandem Awards and Combination Plans

A9. Tandem awards and combination plans are defined in Statement 123.[12] Both Statement 123 and the Proposed IFRS generally treat tandem awards and combination plans similarly for equity instruments issued to employees: (a) equity awards with equal settlement values (tandem awards) are generally accounted for as a liability if the employee can elect cash settlement and as equity if the issuer can elect the form of settlement, (b) equity awards with unequal settlement values (combination plans or compound awards) are valued by first measuring the liability portion and then measuring the equity portion, and (c) the liability and equity portions of compound awards are accounted for as two separate awards.[13]

Differences

Measurement Presumption—Transactions with Nonemployees

A10. Statement 123 states that equity instruments issued for goods or services be valued at the more reliably measurable of (a) the fair value of the goods or services received or (b) the fair value of the equity instruments issued; it does not establish a presumption.[14] However, Statement 123 notes that the fair value of goods or services received from nonemployees is reliably measurable frequently. The Proposed IFRS establishes a rebuttable presumption that the value of goods or services received is more readily determinable in equity instrument transactions with nonemployees.[15] The presumption can be rebutted if, for example, the transaction with a supplier includes an award of equity instruments in addition to cash payments at market rates for goods or services received. This difference should have relatively few practical implications as entities applying Statement 123 to nonemployee transactions will value the consideration received at the more reliably measurable of the consideration received or the equity instruments issued. Generally, an entity must have some rationale that supports its determination of which amount is more reliably measurable.

A11. The Proposed IFRS uses the phrase *more readily determinable* and Statement 123 uses the phrase *more reliably measurable*. Because of the different terminology, some argue that a different conclusion might be reached under the standards given the same set

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[11]Refer to paragraphs 118–134 and 149–154 of Statement 123 and paragraphs BC82–BC104 and BC113–BC121 of the Proposed IFRS.

[12]Refer to the comparative glossary in Appendix I.

[13]Refer to paragraphs 39, 208–218, and 339–347 of Statement 123 and paragraphs 35–44 and BC238–BC249 of the Proposed IFRS.

[14]Refer to paragraph 8 of Statement 123.

[15]Refer to paragraphs 9 and 10 and BC123 of the Proposed IFRS.

of circumstances; not withstanding that argument, the FASB staff understands that the two phrases are intended to operate similarly.

Assumption Selection

A12. Both standards require the use of option-pricing models to measure the fair value of employee stock options. The option-pricing models must take into account the following factors: the exercise price, the expected life of the option, the current price of the underlying stock, the expected volatility of the underlying stock, expected dividends on the underlying stock, and the risk-free interest rate. For factors that include estimates such as expected volatility, expected dividends, or expected option life, an entity must develop a reasonable expectation. In circumstances in which a range of reasonable expectations is developed for a factor and no amount within the range is better than any other amount within the range, Statement 123 permits an entity to choose (a) an amount at the low end of the range for expected volatility and expected option life and (b) an amount at the high end of the range for expected dividends.[16] Statement 123 specifies that this approach is consistent with FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss,* which allows the minimum amount to be used when a range of reasonable expected losses is developed and no amount in the range is more likely than any other. The effect of each election is to lower the option value computed by the option-pricing model. The Proposed IFRS includes implementation guidance on measuring the fair value of equity instruments granted. That guidance specifies that the average of the range should be used in the situation described above.[17,18] The result of this difference is that, all other things being equal, an IFRS-reporting entity will obtain a higher value per equity instrument measured and thus, higher incurred costs than an entity reporting under Statement 123.

A13. For example, Enterprise A, a development-stage enterprise, issues 5,000 options to an employee. In selecting the appropriate factors for use in the option-pricing model, Enterprise A determines the following as of grant date: the exercise price of each option is $5, the expected life of the options is estimated to be within a range of 4 to 6 years, the current price of the underlying stock is $5, the expected volatility of the underlying stock is estimated to be within a range of 75 to 95 percent, and no dividends are expected to be paid on the stock. No amount within the ranges is better than any other amount within the ranges. Under Statement 123, Enterprise A is permitted to use the low end of the range for the expected life of the options, 4 years, and the expected volatility of the underlying stock, 75 percent. The risk-free interest rate for 4 years is 5 percent. The resulting option value is $2.91, or a total award value of $14,550. Under the Proposed

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[16]Refer to paragraph 275 of Statement 123.

[17]Refer to paragraph IG6 of the Implementation Guidance. This implementation guidance is not expected to form part of the final IFRS.

[18]Using the average of the range is more closely aligned with the concepts described in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements.* Paragraph 50 of Concepts Statement 7 indicates, ". . . the estimated expected cash flow is likely to provide a better estimate of fair value than the minimum, most likely, or maximum amount [of a range of estimates] taken alone."

IFRS, Enterprise A must use the average of the range for the expected life of the options, 5 years, and the expected volatility of the underlying stock, 85 percent. The risk-free interest rate for 5 years is 4.25 percent. The resulting option value is $3.47, or a total award value of $17,350.

Issue A2: Do you believe that a probability-weighted average amount of the range should be used when no amount in the range is better than any other? If so, why? If not, what other amount within the range would you propose when no amount in the range is better than any other? Why?

Reload Option

A14. Statement 123 defines *reload option* as an option "that provides for automatic grants of additional options whenever an employee exercises previously granted options using shares of stock, rather than cash, to satisfy the exercise price."[19] Statement 123 stipulates that a reload option grant be measured at its subsequent grant date; however, the Board observed in the basis for conclusions that, ideally, the fair value of the initial option with a reload feature should be estimated at the initial grant date.[20] The IASB noted that academic research indicates that it is possible to value options with reload features at grant date. As a result, the Proposed IFRS specifies that the fair value of options with reload features should be measured at grant date, unless impracticable to do so (in which case, the Proposed IFRS would measure a reload option grant at its subsequent grant date). Essentially, this difference results because of option-pricing models having evolved since the development of Statement 123.

A15. This example illustrates the difference described above. Company A issues 5,000 options that contain a reload feature to an employee at the beginning of period 1. Under Statement 123, the option award is valued at $15,000, whereas under the Proposed IFRS, the option award is valued at $20,000 (that is, the option-pricing model takes into account the estimated value of the reload feature at the initial grant date). The options vest at the end of period 3, over which time Company A recognizes $15,000 and $20,000 of compensation expense under Statement 123 and the Proposed IFRS, respectively. At the end of period 3, the employee exercises 5,000 options when the market price is above the exercise price and pays the exercise price using 2,500 shares of Company A stock. Concurrently, Company A, as a result of the reload feature, issues 2,500 options to the employee with an exercise price equal to the present market price of the shares. Under Statement 123, the subsequent option award is valued at $16,000, whereas under IFRS, the subsequent option award is not valued because the reload feature was already valued at the initial grant date. Thus, Company A reports cumulative compensation expense of $31,000 and $20,000, respectively, under Statement 123 and the Proposed IFRS. Similarly, if the original grant is never exercised because the stock price declines below the exercise price, Company A would recognize $15,000 of compensation cost under Statement 123 and $20,000 of compensation cost under the Proposed IFRS.

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[19]Refer to the comparative glossary in Appendix I.

[20]Refer to paragraphs 34 and 182–186 of Statement 123.

Issue A3: Do you agree that option-pricing techniques have sufficiently evolved since Statement 123 was issued to address reload features and, if so, should Statement 123's requirements be changed? If not, why not?

Not Possible to Reasonably Estimate Fair Value

A16. It may be extremely difficult to reliably measure the fair value of certain equity instruments issued to employees that contain complex features. Statement 123 states that, in unusual circumstances, it may be impossible to reasonably estimate the value of those equity instruments at the grant date. If an entity determines that it cannot reasonably estimate the value of equity instruments issued to employees, Statement 123 requires the entity to measure the intrinsic value of the award and use that measure as an estimate of compensation cost until the first date at which it is possible to determine the fair value of the equity instruments.[21] The Proposed IFRS provides no exception to valuing equity instruments issued at grant date. The IASB considered the approach taken in Statement 123 and determined that (a) it was inconsistent with the grant-date approach because it brings subsequent changes in the underlying stock price into the measurement and (b) it was extremely unlikely that an entity could not reasonably estimate the value of the equity instruments at grant date.[22]

A17. The following scenario is not an example of the difference described in paragraph A16 of this Invitation to Comment; however, it is conceptually related and provides further insight into how the Proposed IFRS functions. Enterprise B hires a CEO. As part of the employment contract, Enterprise B agrees to give 100,000 fully vested stock options at the end of each of the next 5 annual periods (500,000 stock options in total); however, the exercise price of the stock options will be the average market price for the 12 months preceding each separate delivery of options. It is difficult, if not impossible, to reasonably estimate the fair value of the award of stock options at the date the employment contract is signed. However, both Statement 123 and the Proposed IFRS define grant date as the date when both the employer and employee have "a mutual understanding of the terms" of the award. The employer and the employee understand the formula that will establish the exercise price at the date of each individual grant; however, the exercise price is a key term of the options granted over the five-year period and is not known. Consequently, the day the agreement is signed is not the grant date for the award under both Statement 123 and the Proposed IFRS.[23]

Issue A4: Do you believe there are circumstances in which an entity may not be able to reasonably estimate the fair value of equity instruments at the grant date? If so, please provide examples of such circumstances and describe how those equity instruments should be accounted for until a reasonable estimate is determinable.

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[21]Refer to paragraphs 21 and 22 of Statement 123.

[22]Refer to paragraphs BC183–BC190 of the Proposed IFRS.

[23]Some argue that grant date has been achieved in this case and that existent option-pricing models can value this arrangement.

Issue A5: Do you believe there is a single grant date or multiple grant dates for the preceding example? Why?

Stock Appreciation Rights (SARs)

A18. SARs or other stock-based compensation arrangements that obligate the issuing entity to pay cash at a future date in an amount based on the entity's stock price are accounted for similarly under both standards.[24] An entity recognizes compensation expense and the related accrued liability over the vesting period (period over which services are provided to earn the related benefit). The liability is remeasured at each reporting date based on changes in the underlying stock price. Once vesting has occurred, changes in the liability balance from remeasurement are immediately recognized as additional compensation expense (or contra-expense, for example, if the stock price declined from one period to the next).

A19. The only difference is that Statement 123 stipulates that the SAR be measured at its intrinsic value and the Proposed IFRS stipulates that the SAR be measured at its fair value (by applying an option-pricing model). The practical effect of this difference is that cumulative compensation expense will be higher for IFRS-reporting entities until exercise date when the total compensation expense recognized under both standards will be equal (that is, the time value component of the SAR will be equal to zero at exercise date). In other words, an entity reporting under the Proposed IFRS will recognize compensation expense in a different pattern than under Statement 123; however, the total compensation expense recognized under both standards will generally be the same at final settlement. Statement 123 prescribes intrinsic value because, ultimately, the liability will be settled at its intrinsic value. The Proposed IFRS explains that allowing the use of the intrinsic value method to measure the value of the SAR would be an exception to the fair value method established in the Proposed IFRS. Basically, the IASB viewed a SAR like an option for measurement purposes; it noted that a SAR allows the holder the right to participate in future increases in the stock price just as an option does.

Issue A6: Should SARs be measured at fair value rather than intrinsic value? If so, why? If not, why not?

Modifications of Outstanding Awards

A21. Both standards treat modifications of outstanding awards similarly.[25] The standards specify that the fair value of the modified awards is calculated at the grant date of the modification and compared with the fair value of the original award immediately prior to the modification. The incremental value is then recognized over the remaining vesting period of the modified award. Despite the similarities, there are differences as discussed below.

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[24]Refer to paragraphs 25 and 335–338 of Statement 123 and paragraphs 31–34 and BC222–BC237 of the Proposed IFRS.

[25]Refer to paragraphs 34–36 and 187–195 of Statement 123 and paragraphs 26–30 and BC208–BC221 of the Proposed IFRS.

A22. The Boards described slightly different rationales to justify their positions. The FASB concluded that a modification that makes an award more valuable is a deemed exchange of a new option for the original option. This provides the basis for recognizing and measuring the incremental value of the modified award on the modification date. The IASB did not view a modification in that manner; it concluded that a modification represents a change in the original terms and conditions of the original award that should be taken into account at the modification date. The IASB observed that the fair value of a stock option with a repricing feature would be more valuable at grant date than an equivalent option without a repricing feature. Extending this argument, the IASB noted that because it was not possible to value the repricing feature at the grant date (because it was not known that the options would be repriced), the effect of the repricing would be measured at the repricing date, analogous to guidance for options with reload features (that is, if it was impracticable to measure the fair value of equity instruments with a reload feature at the initial grant date, then fair value is measured at the date of each reload grant). While slightly different, both rationales support the premise that the incremental value of the modified award on the modification date should be recognized and measured.

Statement 123

A23. Statement 123 specifies that the fair value of the original award be calculated using the shorter of the remaining expected life of the original award or the expected life of the modified award. The Board concluded that such a provision may preclude an anomalous result in certain instances in which the fair value of the original award, based on the remaining life of the original award, would exceed the fair value of the modified award. For example, Company A issued 1,000 stock options to employees 3 years ago at an exercise price of $15. The current market price of Company A stock is $12. Company A offers to exchange the outstanding options with new options at a strike price of $12. The per-option fair value of the original award is $3.27 using the remaining expected life of 2 years for the original award; the per-option fair value of the new award is $2.95 using its remaining expected life of 1 year. Under Statement 123, Company A would have to use the shorter of the expected option lives in valuing the original award, which results in a per-option fair value of $1.99 and additional compensation cost of $0.96 to be recognized.[26] The Proposed IFRS requires that the fair value of the original and modified awards be measured at the date of modification to calculate the incremental value related to the modification; it does not require that the shorter of the remaining expected life of the original award or the expected life of the modified award be used in measuring the incremental value of the modification.

A24. Another issue is related to modifications that result in the fair value of the modified award being less than the fair value of the original award even when the expected lives are assumed to be the same. In Statement 123, the Board did not conclude on how to account for this situation; it observed the appropriate accounting for such a situation

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[26]Thus, for the facts presented, there is a reduction of compensation cost of $0.32. To some, that is a counterintuitive result of a voluntary employee decision.

would depend on the facts and circumstances.[27] The Proposed IFRS implies that a reduction would be offset by some other benefit in the total remuneration package; however, like Statement 123, the Proposed IFRS does not address how to account for situations in which the incremental value is negative.

A25. Statement 123 addresses repricing events in the context of modifications of outstanding awards; therefore, a repricing event that increases the value of the original award would be accounted for by calculating the incremental value of the new award as described previously. In some cases, an entity offers an employee a new award if the employee agrees to cancel the original award (in effect, the entity has agreed to replace the original award with a new award). The Board concluded in the basis for conclusions that the effects of a modification are indistinguishable from the effects of an exchange of the original award for a new award. Statement 123 does not provide guidance on linking a new award to an award that was cancelled to determine whether the new award is a replacement award or a new award.[28]

Proposed IFRS

A26. The Proposed IFRS gives two approaches for attributing the incremental value of the modified award over the remaining service period: (a) by calculating the incremental value of the units-of-service and recognizing the compensation expense when the units-of-service are received or (b) by calculating a weighted-average value of the units-of-service of the original and modified awards and recognizing compensation expense when the units-of-service are received. The IASB will decide which approach to retain after hearing respondents' views. Paragraphs 39–60 of this Invitation to Comment describe the units-of-service attribution method. The units-of-service attribution method can produce different compensation expense amounts and recognition patterns as compared with Statement 123. Examples 3 and 4 of Appendix B of the Proposed IFRS provide illustrations of how the units-of-service would be calculated in the event of a modification; a comparative illustration demonstrating the different compensation expense amounts and recognition patterns that result if Statement 123 is applied to the same set of facts and circumstances is found in Appendix H of this Invitation to Comment.

A27. The Proposed IFRS addresses situations in which an entity cancels a grant of shares or options during the vesting period; it specifies that if new options are granted to the counterparty, the entity must decide if the new options are replacement options for the original award or not. If they are replacement options, they are treated as a modification of the original award (the entity continues to recognize compensation expense as if the entity had not cancelled the award and the entity recognizes the incremental value of the modification as compensation expense over the period of benefit). If they are not

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[27]Refer to paragraph 190 of Statement 123.

[28]However, paragraph 45 of FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation,* notes that new awards issued within six months of a cancellation are presumed to represent replacement awards. Paragraph 133 of Interpretation 44 indicates that other factors could cause the period for linking the awards to be greater than six months. While Interpretation 44 is not applicable to Statement 123 (that is, it is applicable to Opinion 25), it provides analogous guidance.

replacement options, they are treated as a new award (measured at fair value on the grant date with compensation expense recognized over the period of benefit). The Proposed IFRS provides no guidance for identifying replacement options, just as Statement 123 provides no guidance on linking a new award to an original award.

Example

A28. Company H granted 50,000 stock options with a 5-year service condition to a group of employees. The fair value per option at grant date was $8. After 3 years, Company H's stock price has decreased, and the fair value per option is $0.50. Company H discusses its financial situation with the group of employees that received the award and determines to cancel the entire award of 50,000 options because it will help Company H in its pursuit to obtain additional funding (there was no formal or informal promise given to employees that a new award would be granted). Company H obtains a significant infusion of capital within 10 months of cancelling the award and determines to reissue 50,000 stock options to the same group of employees. The fair value per option at grant date of the new award is $2.50.

A29. Under the Proposed IFRS, Company H continued to recognize compensation expense using the units-of-service attribution method after the award of 50,000 options was cancelled. Company H identifies the new award as a replacement award; therefore, the incremental value per option of $2 ($2.50 – $0.50) is recognized as compensation expense using the units-of-service attribution method. If Company H does not identify the new award as a replacement award, it recognizes the full fair value of $2.50 per option as compensation expense using the units-of-service attribution method.

A30. Under Statement 123, Company H ceases to recognize compensation expense when the award is cancelled. While no cash or other assets were transferred to the employees upon cancellation, the plan has been settled (refer to paragraph A31 of this Invitation to Comment). Because none of the options were vested, the settlement is a deemed vesting acceleration. Company H recognizes the remaining unrecognized compensation expense upon cancellation. If Company H determines that the new award is a replacement award, it recognizes the incremental value of $2 per option as compensation expense over the related vesting period. If Company H determines that the new award is not a replacement award, it recognizes the full fair value of $2.50 per option as compensation expense over the vesting period. The main difference between the two standards in this example, which uses a simplified set of circumstances, is the immediate recognition of previously unrecognized compensation expense under Statement 123.

Issue A7: In accounting for equity award modifications, should the fair value of the original award be calculated using (a) the shorter of the remaining expected life of the original award or the expected life of the modified award or (b) the remaining expected life of the original award? Why?

Issue A8: Do you believe that an accounting standard on stock-based compensation should include provisions for distinguishing between repricing and other modification events? Why?

Settlements of Outstanding Awards

A31. Settlements of outstanding awards by cash payment or transfers of other assets are treated in the same manner under Statement 123 and the Proposed IFRS except in the case of unvested equity instruments. Generally, both standards require that cash payments to holders of vested and unvested equity instruments be treated as the repurchase of an equity interest; however, if the cash payment exceeds the fair value of the equity instruments on the settlement date, the excess is treated as additional compensation expense. Statement 123 considers a settlement of unvested equity instruments as a deemed vesting acceleration event; therefore, any unrecognized compensation cost at the date of settlement is immediately expensed,[29] whereas the Proposed IFRS requires that the entity continue to recognize compensation expense as if the award had not been cancelled or settled.[30] The Proposed IFRS's basis for conclusions discusses the IASB's concern with deemed stock option repricing events such as the cancellation of an old stock option plan followed by the creation of a new stock option plan (assuming that services of the holders are continuous). The IASB considered the approach taken in Statement 123 and felt that it was preferable; however, the Proposed IFRS's measurement philosophy is based on measuring the value of services received. The Proposed IFRS's basis for conclusions explains that there would be no specific amount of unrecognized compensation expense on the settlement date because the amount recognized in the future is based on the number of units-of-service to be received in the future. Also, the Proposed IFRS points out that an entity might partially settle an option grant for cash and issue a replacement award. Since a replacement award is treated as a repricing under the Proposed IFRS, the services received are recognized over the remaining vesting period of the original award. The Proposed IFRS states that having different accounting treatments for awards settled in cash and situations in which replacement awards are granted would be difficult.

Issue A9: Which method of accounting for settlements of unvested awards do you believe is more representationally faithful and why?

Certain Stock-Based Compensation Arrangements—Transactions with Nonemployees

Statement 123

A32. EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," applies to contracts issued to acquire goods or services from nonemployees when performance has occurred.[31] Issue 00-19 requires that such contracts, including stock options granted to nonemployees, be recognized at fair value when initially recorded under Issue 00-19 and be classified on the balance sheet according to their settlement features. Issue 00-19 does not specify how fair value should be determined for those contracts. Generally, stock options that can be

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[29]Refer to paragraphs 37 and 38 of Statement 123.

[30]Refer to paragraphs 29 and BC218–BC221 of the Proposed IFRS.

[31]The Board is reconsidering the consensus reached in Issue 00-19 as part of its liabilities and equity project.

net-cash settled[32] at the option of the counterparty are classified as a liability, whereas stock options that offer a choice of settlement features to the issuer are classified as equity, regardless of the issuer's intent.

A33. For instance, Company N issues stock options that can be net-cash settled or net-share settled[33] at the Company's choice to a nonemployee service provider. The nonemployee performs the service such that a measurement date is achieved under Issue 96-18. Generally, Company N net-cash settles these contracts; however, Issue 00-19 is not based on intent; rather, it sets a presumption that an entity will prefer to issue equity to avoid an outflow of assets. In accordance with Issue 00-19, Company N continues to classify the measurement-date fair value of the stock options in equity.

Proposed IFRS

A34. The Proposed IFRS differs from Issue 00-19 in that the presumption can be overcome if the entity's choice is not substantive, the entity has a history of cash settlement, or the entity has a formal policy of cash settlement. For example, if Company N has (a) a history of net-cash settling contracts that give it the option of settling in net shares or cash or (b) a policy stating that such contracts are cash settled, the Proposed IFRS requires that those contracts be accounted for as cash-settled transactions (that is, as liabilities). Statement 123 provides similar guidance for employee transactions.[34]

A35. The Proposed IFRS also differs from Issue 00-19 in that it specifies how fair value should be determined for contracts that give the counterparty the choice of cash settlement. The Proposed IFRS specifies that such contracts contain a debt component and an equity component. For transactions in which the value of goods or services received is readily determinable, the value of the equity component is obtained by subtracting the value of the debt component from the value of the goods or services received. These components are classified respectively as debt and equity. Under Issue 00-19, stock options, for instance, that provided the counterparty with a choice of net-cash or share settlement, would not be separated into components—they would be treated as liabilities.

Issue A10: The Proposed IFRS considers certain factors, including past practice or a stated policy of settling in cash, in evaluating how an entity should account for certain contracts that can be settled in cash or equity, at the entity's option. Do you agree with this view? If so, why? If not, why not?

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[32]Issue 00-19 describes *net-cash settlement* as follows: the party with a loss delivers to the party with a gain a cash payment equal to the gain, and no shares are exchanged.

[33]Issue 00-19 describes *net-share settlement* as follows: the party with a loss delivers to the party with a gain shares with a current fair value equal to the gain.

[34]Refer to paragraph 39 of Statement 123.

DISCLOSURE

A36. No similarities or differences were classified as secondary in this section. Primary items are described in this Invitation to Comment.

TRANSITION

A37. In October 2002, the FASB issued an Exposure Draft of a proposed Statement that would allow an entity voluntarily adopting Statement 123 to choose among three transition alternatives: prospective application to new awards, prospective application for new and unvested awards, and retroactive restatement.[35] The amended transition provisions of the proposed Statement would be effective for fiscal years ending after December 15, 2002. The IASB Proposed IFRS requires that the standard be applied prospectively to equity-settled stock-based compensation granted after November 7, 2002, and not yet vested as of the effective date. The standard's proposed effective date is for periods beginning on or after January 1, 2004 (assuming a final IFRS is issued by then). Further, the IASB Proposed IFRS requires that the standard be applied retrospectively to liabilities arising from stock-based compensation at the effective date, except liabilities that are vested at the effective date, which will be measured at their settlement value (for example, intrinsic value for a SAR) rather than fair value.[36]

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[35]A copy of the FASB Exposure Draft, *Accounting for Stock-Based Compensation—Transition and Disclosure,* can be obtained from the FASB website, www.fasb.org.

[36]Refer to paragraphs 54 and 55 of the Proposed IFRS.

APPENDIX B: ISSUES FOR RESPONDENTS

B1. This appendix presents the complete list of issues related to the primary and secondary similarities and differences that the Board would like respondents to consider when commenting on the Invitation to Comment. The analysis and discussion related to those issues are included in the Invitation to Comment and Appendix A.

PRIMARY SIMILARITIES AND DIFFERENCES FROM INVITATION TO COMMENT

Issue 1: Statement 123 provides a scope exclusion for ESOPs and certain ESPPs, and the Proposed IFRS does not. Which view do you support and why? (Refer to page 19.)

Issue 2: In measuring the fair value of stock options granted to employees, both Statement 123 and the Proposed IFRS require use of an option-pricing model that takes into account six specific assumptions. The standards provide supplemental guidance for use in selecting those assumptions. (Refer to page 20.)

Issue 2(a): Do you believe that an accounting standard should mandate the use of an option-pricing model for measurement purposes? If not, what other approaches do you believe would provide more consistent and reliable estimates of the fair value of employee stock options granted and why? (Refer to page 21.)

Issue 2(b): If you agree that an accounting standard should mandate the use of an option-pricing model, do you believe that a particular model should be mandated? If so, which model should be required to be used and why? (Refer to page 21.)

Issue 2(c): If you agree that an accounting standard should not mandate the use of a particular option-pricing model, do you believe that additional disclosures should be made to improve the user's ability to compare the reported financial results of different enterprises? If so, what types of additional information should be required to be disclosed? (Refer to page 21.)

Issue 2(d): Statement 123 and the Proposed IFRS require that certain modifications be made to the outcome of an option-pricing model to address certain features of employee stock options. If you believe that other modifications should be made to improve the consistency and reliability of those outcomes, please describe those modifications and why they should be required. (Refer to page 21.)

Issue 2(e): Do you believe that additional guidance for selecting the factors used in option-pricing models is necessary to provide added consistency and comparability of reported results? If so, what types of guidance should be provided and in which areas? (Refer to page 21.)

Issue 3: Do you believe that employee and nonemployee transactions are distinct and, therefore, warrant different measurement dates for determining the fair value of equity instruments granted? If so, why? If not, why not? (Refer to page 24.)

Issue 4: Do you believe that the fair value of equity awards granted to nonemployees that include performance conditions can be measured with sufficient reliability to justify a grant-date measurement method? If so, why? If not, why not? (Refer to page 24.)

Issue 5: Do you believe the notion of issuance is conceptually of importance in the design of a standard on stock-based compensation? If so, why? If not, why not? (Refer to page 25.)

Issue 6: Do you believe an equity instrument subject to vesting or other performance conditions is issued, as defined by Statement 123, at the grant date? If so, why? If not, why not? (Refer to page 25.)

Issue 7: Do you believe that the effect of forfeiture should be incorporated into the estimate of fair value per equity instrument (IASB approach)? If so, why? If not, why not? (Refer to page 28.)

Issue 8: Should failure of an award holder to satisfy the conditions that entitle the holder to retain or receive the promised benefits affect the amount of compensation expense that should be recognized related to that award? If so, why? If not, why not? (Refer to page 28.)

Issue 9: Do you agree that the result of the IASB's approach to calculate the fair value of equity instruments of nonpublic entities would be closer to fair value than minimum value? If so, why? If not, why not? (Refer to page 29.)

Issue 10: Which of the two attribution methods described by the standards do you believe is more representationally faithful of the economics of stock-based compensation arrangements and why? (Refer to page 35.)

Issue 11: Statement 123 does not ascribe value to services received in exchange for equity instruments that are later forfeited (that is, recognized compensation expense is reversed upon forfeiture), whereas the Proposed IFRS ascribes value to such services through its units-of-service attribution method (that is, recognized compensation expense is not reversed upon forfeiture). If you support the Proposed IFRS's view, do you believe the units-of-service method ascribes an appropriate value to services received prior to forfeiture? If so, why? If not, why not? (Refer to page 35.)

Issue 12: Do you believe that the actual outcome of performance awards should affect the total compensation expense incurred by an enterprise? If so, why? If not, why not? (Refer to page 38.)

Issue 13: Do you believe that this issue is important in considering an attribution model's validity? If so, why? If not, why not? (Refer to page 40.)

Issue 14: Do you believe that the measurement-date criteria in Issue 96-18 accurately reflect the economics of transactions with nonemployees? If not, why not? (Refer to page 43.)

Issue 15: Do you believe that all of the tax benefits derived from stock-based compensation arrangements should be recognized in the income statement? If so, why? If not, why not? (Refer to page 46.)

Issue 16: As discussed in paragraph 83 of this Invitation to Comment, the Proposed IFRS expands on the disclosure requirements in Statement 123. Do you believe that those expanded disclosures would be more informative to users of financial statements? If so, why? If not, why not? (Which of the disclosure requirements should be eliminated or modified in that case?) (Refer to pages 47 and 48.)

Issue 17: Please describe any additional disclosures that you believe should be required in order to inform a user of financial statements about the economics of stock-based compensation arrangements. (Refer to page 48.)

SECONDARY SIMILARITIES AND DIFFERENCES FROM APPENDIX A

Issue A1: Statement 123 distinguishes between a principal stockholder and a stockholder for certain transactions, and the Proposed IFRS does not. Which view do you support and why? (Refer to page 52.)

Issue A2: Do you believe that a probability-weighted average amount of the range should be used when no amount in the range is better than any other? If so, why? If not, what other amount within the range would you propose when no amount in the range is better than any other? Why? (Refer to page 56.)

Issue A3: Do you agree that option-pricing techniques have sufficiently evolved since Statement 123 was issued to address reload features and, if so, should Statement 123's requirements be changed? If not, why not? (Refer to page 57.)

Issue A4: Do you believe there are circumstances in which an entity may not be able to reasonably estimate the fair value of equity instruments at the grant date? If so, please provide examples of such circumstances and describe how those equity instruments should be accounted for until a reasonable estimate is determinable. (Refer to page 57.)

Issue A5: Do you believe there is a single grant date or multiple grant dates for the preceding example? Why? (Refer to page 58.)

Issue A6: Should SARs be measured at fair value rather than intrinsic value? If so, why? If not, why not? (Refer to page 58.)

Issue A7: In accounting for equity award modifications, should the fair value of the original award be calculated using (a) the shorter of the remaining expected life of

the original award or the expected life of the modified award or (b) the remaining expected life of the original award? Why? (Refer to page 61.)

Issue A8: Do you believe that an accounting standard on stock-based compensation should include provisions for distinguishing between repricing and other modification events? Why? (Refer to page 61.)

Issue A9: Which method of accounting for settlements of unvested awards do you believe is more representationally faithful and why? (Refer to page 62.)

Issue A10: The Proposed IFRS considers certain factors, including past practice or a stated policy of settling in cash, in evaluating how an entity should account for certain contracts that can be settled in cash or equity, at the entity's option. Do you agree with this view? If so, why? If not, why not? (Refer to page 63.)

APPENDIX C: INTERPRETATIONS OF OPINION 25 AND RELATED EITF ISSUES

C1. The interpretations of APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and related EITF Issues include the following guidance:

- AICPA Accounting Interpretation 1 of Opinion 25, "Stock Plans Established by a Principal Stockholder"
- FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*
- FASB Interpretation No. 38, *Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock*
- FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*
- EITF Issue No. 84-13, "Purchase of Stock Options and Stock Appreciation Rights in a Leveraged Buyout"
- EITF Issue No. 84-18, "Stock Option Pyramiding"
- EITF Issue No. 84-34, "Permanent Discount Restricted Stock Purchase Plans"
- EITF Issue No. 85-45, "Business Combinations: Settlement of Stock Options and Awards"
- EITF Issue No. 87-23, "Book Value Stock Purchase Plans"
- EITF Issue No. 88-6, "Book Value Stock Plans in an Initial Public Offering"
- EITF Issue No. 90-7, "Accounting for a Reload Stock Option"
- EITF Issue No. 95-16, "Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25"
- EITF Issue No. 97-2, "Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements"
- EITF Issue No. 97-5, "Accounting for the Delayed Receipt of Option Shares upon Exercise under APB Opinion No. 25"
- EITF Issue No. 97-12, "Accounting for Increased Share Authorizations in an IRS Section 423 Employee Stock Purchase Plan under APB Opinion No. 25"

- EITF Issue No. 97-14, "Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested"

- EITF Issue No. 00-12, "Accounting by an Investor for Stock-Based Compensation Granted to Employees of an Equity Method Investee"

- EITF Issue No. 00-15, "Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option"

- EITF Issue No. 00-16, "Recognition and Measurement of Employer Payroll Taxes on Employee Stock-Based Compensation"

- EITF Issue No. 00-23, "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44"

- EITF Issue No. 02-8, "Accounting for Options Granted to Employees in Unrestricted, Publicly Traded Shares of an Unrelated Entity"

- EITF Topic No. D-83, "Accounting for Payroll Taxes Associated with Stock Option Exercises"

- EITF Topic No. D-91, "Application of APB Opinion No. 25 and FASB Interpretation No. 44 to an Indirect Repricing of a Stock Option."