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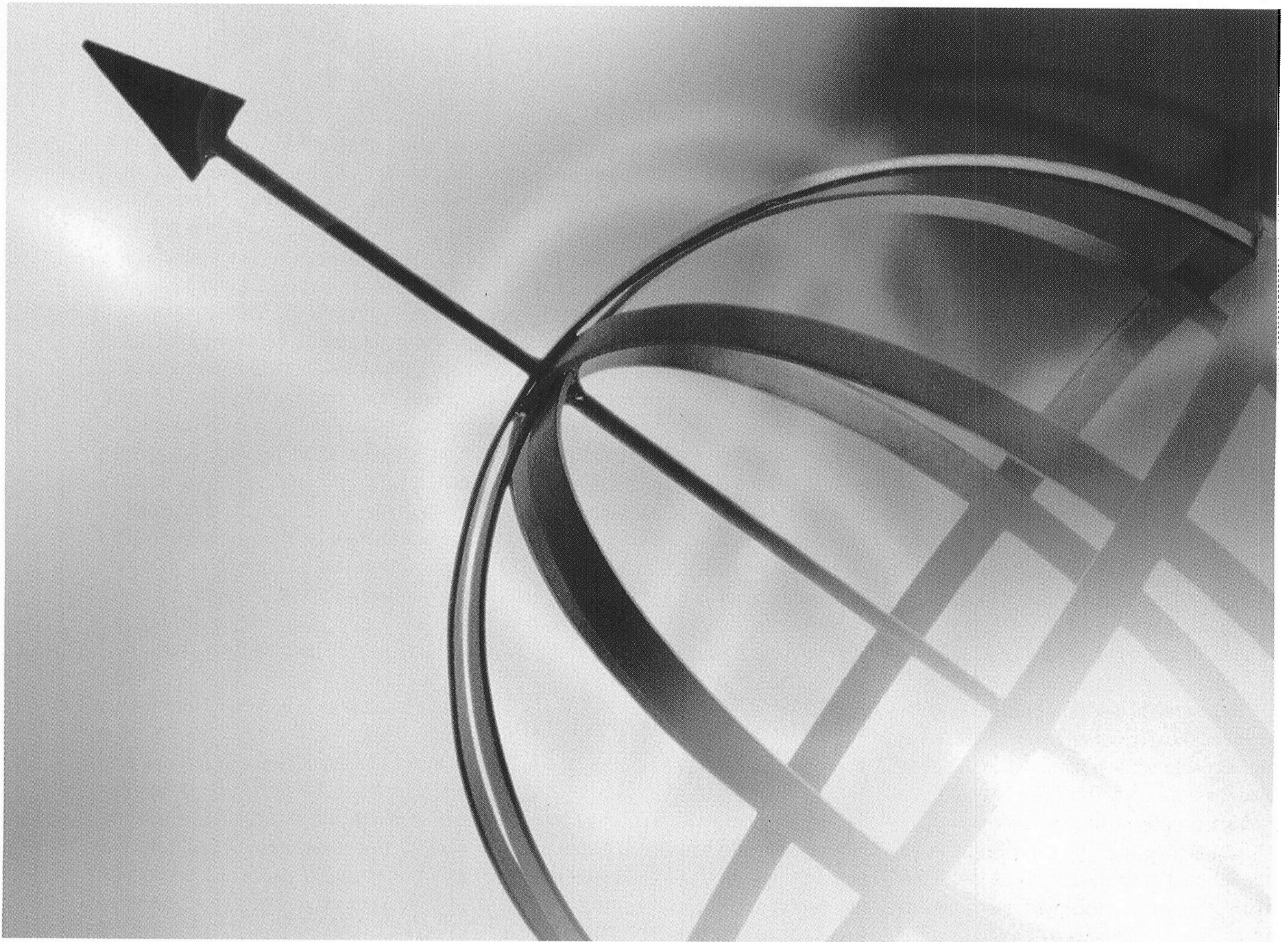

Transitioning to the Fair Value Method

Changes in Accounting for Employee Stock Options

By Stephen R. Moehrle and Jennifer A. Reynolds-Moehrle

Since 1995, when FASB issued SFAS 123, *Accounting for Stock-Based Compensation*, companies have had the option to use the fair value method of accounting for employee stock options. Until recently, however, most companies continued to use the intrinsic value method of APB 25.

Recently, as part of an overall strategy to restore market confidence in their financial reporting, many companies have voluntarily adopted the fair value method. As a result, the FASB recently issued SFAS 148, *Accounting for Stock-Based Compensation—Transition and Disclosure*, which amends SFAS 123, to provide guidance on the transition from the intrinsic value method to the fair value method, and an exposure draft that would require expensing all stock options.

Even before adopting the fair value method, companies had to calculate the fair value of options, but the impact on earnings was simply disclosed in a footnote. FASB applauds companies that adopt the fair value method, and its recently released exposure

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draft, *Share-Based Payment, an Amendment of FASB Statements 123 and 95*, would recognize all share-based payments in the income statement. The International Accounting Standards Board (IASB) also recently released International Financial Reporting Standard (IFRS) 2, *Share-Based Payment*, which requires companies to recognize share-based payment transactions in their income statement.

SFAS 148 illustrates several alternative methods for companies transitioning from the intrinsic value method to the fair value method. The comparability and consistency of the information provided in the year of fair value method adoption differs widely depending upon the transition method chosen. Likewise, financial statement users must recognize the transition method applied and understand its ramifications in order to interpret the resulting disclosures.

Background

Under the intrinsic value method [Accounting Principles Board (APB) Opinion No. 25], the intrinsic value of stock options granted to employees is reported as compensation expense. The intrinsic value of stock options is the amount by which the price of the underlying stock exceeds the exercise price at the date of measurement; that is, the earliest date that both the number of options and the option price are known. For most employee stock plans, the intrinsic value of the options at the measurement date is zero because the option price is set equal to the market price at the date that the options are granted.

Under the fair value method (SFAS 123), the fair value of stock options granted to employees is reported as compensation expense. Even if the market price of the stock is equal to the exercise price of the option, the option will have positive fair value because it can be exercised in the future, when the market price may exceed the exercise price. The tax effect of stock options is the same regardless of the accounting method chosen. The IRC allows companies to take a tax deduction for the amount by which the market price exceeded the option price when the options were exercised.

Transitioning to the Fair Value Method

SFAS 148 sets forth guidance for companies expensing stock options for the first time. Under the proposal, companies transitioning to the fair value method can choose either a "prospective," a "modified prospective," or a "retroactive restatement" transition method. SFAS 123 required prospective transition to the fair value method. While prospective transition created a one-time increase in compensation expense that hindered consistency with prior-period amounts and comparability with other companies, prospective transition was necessary as a practical matter because few companies had the historical information necessary to retroactively restate prior periods. Today, retroactive transition to the fair value method is a viable option because even companies that have continued to use the intrinsic value method have had to prepare pro forma disclosures under the fair value method for several years.

Prospective transition method. This approach recognizes the fair value of stock options granted after the beginning of the fiscal year in which the company adopts the fair value method as compensation cost. Companies adopting the fair value method in 2003 would accrue the fair value of stock options awarded to employees in 2003 as compensation cost. This total compensation cost would then be allocated over the required service period (generally the vesting period) before the options can be exercised. The prospective transition option has been eliminated for companies adopting the fair value method in fiscal years beginning after December 15, 2003.

Modified prospective transition method. This approach recognizes stock compensation cost in the transition year totaling the amount that would have been recognized had the fair value method been applied since the effective date of SFAS 123 (fiscal years beginning after December 15, 1994). Under this alternative, the total option compensation expense reported in 2003 would include an allocation of the fair value of options issued in 2003, as well as an allocation of the fair value of options issued between 1995 and 2002 that have not yet expired.

Retroactive restatement transition method. This approach also recognizes stock compensation cost in the transition year totaling the amount that would have been recognized had the fair value method been applied for fiscal years beginning after December 15, 1994. In addition, all prior years' financial statements would be restated as if the fair value method had been applied since 1995. The effect on total compensation expense and income tax expense would be the same as described in the second alternative above. The impact on deferred tax assets and retained earnings is demonstrated in the following illustration.

Illustration of the Transition Alternatives

To illustrate the provisions described above, consider the following example:

ABC Company decided to adopt the fair value method as of the fiscal year beginning January 1, 2003. The earliest year for which an income statement and balance sheet will be presented in ABC's 2003 Annual Report is 2001. ABC assumes a marginal tax rate of 50%.

Retroactive transition is a viable option because even companies that have continued to use the intrinsic value method have had to prepare pro forma disclosures under the fair value method for several years.

On January 1, 1999, ABC grants its employees options to purchase 100,000 shares of ABC common stock at $10 per share, the current market price. All of the options vest five years from the grant date.

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The fair value of each option is estimated to be $6. Total fair value–related compensation costs under this plan are $600,000. As a result, $120,000 would be allocated to each of the five service years required for vesting under the fair value method:

Year	Compensation Expense	Deferred Tax Benefit
1999	$120,000	$60,000
2000	$120,000	$60,000
2001	$120,000	$60,000
2002	$120,000	$60,000
2003	$120,000	$60,000

On January 1, 2003, ABC grants its employees options to purchase 200,000 shares of ABC common stock at $25 per share, the current market price. All of the options vest five years from the grant date. The fair value of each option is estimated to be $15. Total fair value–related compensation cost under this plan is $3 million. As a result, $600,000 would be allocated to each of the five service years required for vesting under the fair value method:

Year	Compensation Expense	Deferred Tax Benefit
2003	$600,000	$300,000
2004	$600,000	$300,000
2005	$600,000	$300,000
2006	$600,000	$300,000
2007	$600,000	$300,000

Prospective transition method. Under the prospective transition method, ABC would report stock award–related compensation expenses totaling $600,000 in 2003, which is the allocation of compensation cost for the options awarded during the year of transition to the fair value method. Net of the related tax benefit, net income and retained earnings would be reduced by $300,000 due to stock award–related compensation. On its balance sheet, ABC would report a deferred tax asset totaling $300,000 and contributed capital totaling $600,000. All of these amounts are related to the stock options awarded in 2003.

Modified prospective transition method. Under the modified prospective transition method, ABC would record a deferred tax asset balance totaling $240,000 at the beginning of 2003, which represents the deferred tax benefit accrued to date related to the stock options awarded in 1999. Additional paid-in capital is credited for the difference. No cumulative effect of a change in accounting principle is presented when transitioning to the fair value method. Had ABC been using the fair value method all along, the contributed capital account related to stock options would contain a $480,000 credit balance offset by reduced retained earnings from the net of tax compensation expense totaling $240,000. Thus, total equity is the same although the net amount is recorded in an additional paid-in capital account upon the transition.

During 2003, ABC would report stock award–related compensation expense totaling $720,000 in 2003, which consists of compensation expense of $120,000 related to options awarded in 1999 and $600,000 related to options awarded in 2003. Net of the related tax benefit, net income would be reduced by $360,000 for the after-tax effect of stock award–related compensation.

Retroactive restatement transition method. Under the retroactive restatement transition method, at the beginning of 2003 ABC would restate all periods shown as if the fair value method had been applied all along. As a result, ABC would report deferred tax asset balances totaling $180,000 and $240,000 on the 2001 and 2002 balance sheets, respectively, and would report contributed capital from stock options totaling $360,000 and $480,000 in 2001 and 2002, respectively. Retained earnings would be restated downward by $180,000 in 2001 and $240,000 in 2002 to reflect the effect of the after-tax stock award–related compensation expense.

ABC would report stock award–related compensation expense totaling $120,000 in 2001 and 2002 related to the options awarded in 1999. Income tax expense would be reduced by $60,000 as a result. In 2003, ABC would report stock award–related compensation expense totaling $720,000, consisting of the allocation of compensation cost for the options awarded in 1999 and the options awarded in 2003. Net of the related tax benefit, net income would be reduced by $360,000 for the after-tax effect of stock award–related compensation.

The transition strategy used by a company is an important decision that can greatly impact the relative consistency and comparability of the resulting information.

A Transition Period

In an attempt to restore faith in financial reporting, many companies are voluntarily adopting the fair value method of accounting for stock options. It appears increasingly likely that FASB will ultimately prohibit the intrinsic value method altogether. SFAS 148 provides guidance for companies transitioning to the fair value method.

The transition strategy used by a company is an important decision that can greatly impact the relative consistency and comparability of the resulting information. Likewise, it is important for financial statement users to understand the transition strategy used so that they can appropriately interpret the result. Companies should also note that the prospective transition method will not be available for fiscal years beginning after December 15, 2003. ❑

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