Statement of Financial Accounting Standards No. 148

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FAS148 Summary

Accounting for Stock-Based Compensation—Transition and Disclosure

an amendment of FASB Statement No. 123

December 2002

Financial Accounting Standards Board
of the Financial Accounting Foundation
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Statement of Financial Accounting Standards No. 148

Accounting for Stock-Based Compensation—Transition and Disclosure

an amendment of FASB Statement No. 123

December 2002

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FAS 148: Accounting for Stock-Based Compensation—Transition and Disclosure

an amendment of FASB Statement No. 123

Summary

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

Reasons for Issuing This Statement

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

A number of companies have recently adopted or announced their intention to adopt the fair value based method of accounting for stock-based employee compensation. To respond to concerns raised by constituents, including financial statement preparers' concerns about the ramp-up effect arising from the transition method prescribed by Statement 123 and financial statement users' concerns about the lack of consistency and comparability in reported results caused by that transition method, this Statement requires new disclosures about the effect of stock-based employee compensation on reported results. This Statement also requires that those effects be disclosed more prominently by specifying the form, content, and location of those disclosures.

How the Changes in This Statement Improve Financial Reporting

This Statement permits two additional transition methods for entities that adopt the preferable method of accounting for stock-based employee compensation. Both of those methods avoid the ramp-up effect arising from prospective application of the fair value based method. In addition, to address concerns raised by some constituents about the lack of comparability caused by multiple transition methods, this Statement does not permit the use of the original Statement 123 prospective method of transition for changes to the fair value based method made in fiscal years beginning after December 15, 2003.

Also, in the absence of a single accounting method for stock-based employee compensation, this Statement requires disclosure of comparable information for all companies regardless of whether, when, or how an entity adopts the preferable, fair value based method of accounting. This Statement improves the prominence and clarity of the pro forma disclosures required by Statement 123 by prescribing a specific tabular format and by requiring disclosure in the "Summary of Significant Accounting Policies" or its equivalent. In addition, this Statement improves the timeliness of those disclosures by requiring their inclusion in financial reports for interim periods.

International Convergence

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

The Board has been actively working with the IASB and other major national standard setters to bring about convergence of accounting standards across the major world capital markets. In particular, the Board and the FASB staff have been monitoring the IASB's deliberations on share-based payments and, in November 2002, issued an Invitation to Comment summarizing the IASB's proposal and explaining the key similarities of and differences between its provisions and current U.S. accounting standards. In the near future, the Board plans to consider whether it should propose changes to the U.S. standards on accounting for stock-based compensation.

INTRODUCTION

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

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to Statement 123

2. Statement 123 is amended as follows:

Amendments to Transition Provisions

a. Paragraph 52 is replaced by the following:

> If an entity elects to adopt the recognition provisions of this Statement for stock-based employee compensation in a fiscal year beginning before December 16, 2003, that change in accounting principle shall be reported using any one of the following methods:
>
> a. *Prospective method.* Apply the recognition provisions to all employee awards granted, modified, or settled after the beginning of the fiscal year in which the recognition provisions are first applied.
> b. *Modified prospective method*. Recognize stock-based employee compensation cost from the beginning of the fiscal year in which the recognition provisions are first applied as if the fair value based accounting method in this Statement had been used to account for all employee awards granted, modified, or settled in fiscal years beginning after December 15, 1994.
> c. *Retroactive restatement method.* Restate all periods presented to reflect stock-based employee compensation cost under the fair value based accounting

method in this Statement for all employee awards granted, modified, or settled in fiscal years beginning after December 15, 1994. Restatement of periods prior to those presented is permitted but not required. The restated net income and earnings per share of prior periods shall be determined in a manner consistent with the requirements of paragraphs 12, 13, and 45 of this Statement.

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

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

If an entity elects to adopt the recognition provisions of this Statement for stock-based employee compensation in fiscal years beginning after December 15, 2003, that change in accounting must be reported using either the method described in paragraph 52(b) or the method described in paragraph 52(c).

c. The following new paragraph 52B is inserted after paragraph 52A:

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

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

Examples of determining and recording that adjustment are included in Appendix B of Statement 148. For those entities that elect retroactive restatement, any effect on additional paid-in capital or retained earnings arising from the restatement of periods subsequent to the period of initial application of the fair value based method but prior to the earliest period for which an income statement is presented should be reported as an adjustment to those accounts as of the beginning of the earliest period for which an income statement is presented. The transition adjustment as well as the effect of restatement of intervening periods, if any, should be disclosed in the year of adoption.

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

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

Amendments to Disclosure Provisions

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

Regardless of the method used to account for stock-based employee compensation arrangements, the financial statements of an entity shall include the disclosures specified in paragraphs 46–48. All entities shall disclose the following information in the "Summary of Significant Accounting Policies" or its equivalent: *

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

The required pro forma amounts shall reflect the difference in stock-based employee compensation cost, if any, included in net income and the total cost measured by the fair value based method, as well as additional tax effects, if any, that would have been recognized in the income statement if the fair value based method had been applied to all awards. The required pro forma per share amounts shall reflect the change in the denominator of the diluted earnings per share calculation as if the assumed proceeds under the treasury stock method, including measured but unrecognized compensation cost and the excess tax benefits credited to additional paid-in capital, were determined under the fair value based method. Examples of the required tabular presentation are included in Appendix B of FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure*.

f. The second sentence of paragraph 53 is deleted.

Amendment to Opinion 28

3. The following is added to the list of disclosures in paragraph 30 of Opinion 28:

j. The following information about stock-based employee compensation costs, disclosed prominently and in tabular form for all periods presented pursuant to the provisions of FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure,* if awards of stock-based employee compensation were outstanding and accounted for under the intrinsic value method of Opinion 25 for any period for which an income statement is presented:

(1) Net income and basic and diluted earnings per share as reported

(2) The stock-based employee compensation cost, net of related tax effects, included in the determination of net income as reported

(3) The stock-based employee compensation cost, net of related tax effects, that would have been included in the determination of net income if the fair value based method had been applied to all awards *

(4) Pro forma net income as if the fair value based method had been applied to all awards

(5) Pro forma basic and diluted earnings per share as if the fair value based method had been applied to all awards.

Effective Dates

4. The amendments to Statement 123 in paragraphs 2(a)–2(e) of this Statement shall be effective for financial statements for fiscal years ending after December 15, 2002. Earlier application of the transition provisions in paragraphs 2(a)–2(d) is permitted for entities with a fiscal year ending prior to December 15, 2002, provided that financial statements for the 2002 fiscal year have not been issued as of the date this Statement is issued. Early application of the disclosure provisions in paragraph 2(e) is encouraged.

5. The amendment to Statement 123 in paragraph 2(f) of this Statement and the amendment to Opinion 28 in paragraph 3 shall be effective for financial reports containing condensed financial statements for interim periods beginning after December 15, 2002. Early application is encouraged.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Robert H. Herz, Chairman
G. Michael Crooch
John M. Foster
Gary S. Schieneman
Katherine Schipper
Edward W. Trott
John K. Wulff

Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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Appendix A: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

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

Background Information

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

A3. Prior to the issuance of Statement 123, companies had not been gathering the necessary information or making the necessary assumptions to measure the fair value of employee stock options. Therefore, although the Board acknowledged that the "ramp-up" effect [1] created by the prospective transition method was undesirable, the Board decided to require prospective application because retroactive application would have required preparers of financial statements to make numerous assumptions in order to estimate the grant date fair value of previously issued stock-based awards. [2] In 2002, however, seven years after the issuance of Statement 123, historical information necessary for retroactive application of the recognition provisions of Statement 123 is available.

A4. A number of companies have recently elected to adopt the fair value recognition provisions of Statement 123 for stock-based employee compensation awards. In conjunction with those decisions, a number of companies, as well as financial statement users, expressed concern to the Board about the lack of comparability and consistency of reported results between periods caused by the ramp-up effect inherent in the requirement to adopt the fair value based method prospectively.

A5. In August 2002, the Board decided to add a limited-scope project to its agenda to reconsider the transition and disclosure provisions of Statement 123. The principal objective of that project was to address the concerns of preparers and users about the comparability and consistency of reported results in light of the increased number of entities electing to adopt the fair value based method of accounting for stock-based employee compensation. Because of the Board's commitment to international convergence of accounting standards and the ongoing International Accounting Standards Board project on share-based payment, the Board decided not to reconsider the recognition and measurement provisions of Statement 123, including the optional use of the intrinsic value method, in the context of this limited-scope project. Reconsideration of the accounting for stock-based compensation has been deferred pending receipt of feedback from constituents on the November 2002 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.

A6. In October 2002, the Board issued an Exposure Draft, *Accounting for Stock-Based Compensation—Transition and Disclosure,* for a 30-day comment period. The Board received 70 comment letters on the Exposure Draft. In November 2002, the Board redeliberated the issues identified in the Exposure Draft and concluded that on the basis of existing information, it could reach an informed decision on the matters addressed in this Statement without a public hearing.

Basis for Conclusions

Transition Alternatives

A7. In its deliberations leading to the issuance of the Exposure Draft, the Board considered three possible transition methods in addition to prospective application to new awards [3] (the "prospective" method) prescribed by Statement 123:

a. Cumulative effect of a change in accounting principle under APB Opinion No. 20, *Accounting Changes*
b. Retroactive restatement
c. Prospective recognition for unvested awards and new awards (the "modified prospective" method).

Cumulative Effect of a Change in Accounting Principle

A8. During the deliberations leading to the Exposure Draft, the Board rejected the cumulative effect of a change in accounting principle method primarily because the cumulative effect, in the case of a change from the intrinsic value method to the fair value based method, would be the cumulative effect only from the original effective date of Statement 123 and, therefore, would not represent a meaningful amount. In addition, some preparers and users of financial statements expressed concern over the confusion often created by including the cumulative effect of a change in accounting principle in the determination of current period net income. The Board also noted that the cumulative effect from this particular accounting change generally would result in a reduction in retained earnings offset by an increase in additional paid-in capital. A number of respondents were concerned about the implications for future voluntary accounting changes of the Board's rejection of the cumulative effect transition method prescribed by Opinion 20. The Board's rejection of that method, however, stems from the unique characteristics of this particular accounting change and is not intended to imply that the Board has reconsidered the appropriateness of that method for voluntary accounting changes in general.

Retroactive Restatement

A9. The retroactive restatement method, as used in this Statement, refers to the restatement of prior periods' reported net income to give effect to the fair value based method of accounting for awards granted, modified, or settled in fiscal years beginning after December 15, 1994, on a basis consistent with the pro forma disclosures required by Statement 123. Retroactive application to awards made in periods beginning before that date involves the problems cited by the Board in originally rejecting retroactive application and would likely result in restated amounts different from those pro forma amounts previously disclosed in financial statements.

A10. During the deliberations leading to the Exposure Draft, the Board considered the views of some financial statement users who suggested that the Board require retroactive restatement for reporting this change in accounting. Board members agreed that retroactive application maximizes consistency between periods and comparability among companies. The Board also considered the views of some preparers who echoed the Accounting Principles Board's concerns expressed in Opinion 20 that the restatement of prior-period results detracts from the credibility of reported results.

Modified Prospective Method

A11. Some preparers suggested that both the ramp-up effect of prospective application and the perceived credibility issue of retroactive restatement could be avoided by prospectively applying the fair value recognition provisions of Statement 123 to the unvested portion of previously issued awards and unvested variable awards as well as new awards. Under that approach, the stock-based employee compensation cost recognized in the year of adoption would be the same as that which would be recognized if the company had applied the retroactive restatement method.

Multiple Transition Methods

A12. The Exposure Draft reflected the Board's decision to allow multiple transition methods. The majority of respondents disagreed with that decision, citing the arguments considered by the Board in the deliberations leading to the Exposure Draft, but were divided as to which of the proposed transition methods they preferred. The Board acknowledges the arguments cited by respondents, which confirm that preparers' and users' concerns are primarily related to the lack of comparability and consistency arising from (a) the ramp-up effect resulting from prospective application and (b) the existence of multiple transition methods. However, because a choice of accounting methods for stock-based employee compensation continues to exist—intrinsic value or fair value—comparability is impaired currently. As stated in paragraph A19, the Board believes that the new disclosures required by this Statement mitigate those concerns about comparability by providing information that enables users of financial statements to make comparisons.

A13. Although information is now available to facilitate retroactive application, the Board notes that the guidance in Statement 123 is unambiguous—it requires prospective application to awards granted, modified, or settled after the beginning of the period of adoption. Therefore, in the deliberations leading to the Exposure Draft, the Board decided that it would be inappropriate to preclude the existing Statement 123 transition method, particularly for those companies that previously had decided to adopt the preferable method of accounting in accordance with that Statement. However, the Board was persuaded by respondents' comments that the practical argument for retaining the prospective method no longer exists. Therefore, the Board decided that the prospective method would no longer be permitted for those entities adopting the fair value based method of accounting for stock-based employee compensation in fiscal years beginning after December 15, 2003.

A14. During its redeliberations, the Board affirmed its decision to permit both the retroactive restatement method and the modified prospective method because (a) both methods address the ramp-up effect and (b) the reported amount of stock-based compensation cost determined under either method will be the same in the period of adoption and all subsequent periods. The Board decided not to *require* restatement for an entity that *voluntarily* adopts the preferable accounting method because, for the reasons cited in paragraph A12, concerns about comparability and consistency continue to exist. The Board believes that the amended disclosures, which are required for all companies except those that adopt the fair value based method using the retroactive restatement method of transition, provide information that will mitigate any additional comparability concerns caused by the decision to permit multiple transition methods.

Accumulated Opinion 25 Balances

A15. The modified prospective method and the retroactive restatement method (if fewer than all of the periods since the original effective date of Statement 123 are restated) raise the issue of accounting for the accumulated deferred compensation, if any, and related deferred income tax balances that arose from the application of Opinion 25. In the deliberations leading to the Exposure Draft, the Board concluded that the carrying amounts of those items should be reversed and that any required beginning balances under Statement 123 relating to unvested awards should be recorded with the effect recognized in additional paid-in capital. The Opinion 25 balances and Statement 123 balances both ultimately increase additional paid-in capital for the value of the employee services received. However, because the two accounting models under which those balances arise are fundamentally different, the Board decided not to require reclassifications between retained earnings (either directly or through the income statement) and additional paid-in capital because doing so would be tantamount to reporting the cumulative effect of a change in accounting principle, which, as described in paragraph A8, the Board believes would not provide useful information to financial statement users about the change from the intrinsic value method to the fair value based method. Of those respondents that addressed the accounting for the transition effect, most agreed with the Board's decision, and the Board affirmed that decision during redeliberations.

Accounting for Excess Tax Benefits

A16. Under Statement 123, the write-off of deferred tax assets recognized in excess of the tax benefit ultimately realized from the exercise of employee stock options reduces net income unless there are accumulated balances in additional paid-in capital related to previous excess tax benefits related to awards accounted for under the fair value based method of Statement 123. In that case, the write-off of those excess deferred tax assets reduces additional paid-in capital. In developing the Exposure Draft, the Board decided that the determination of whether sufficient excess tax benefits are accumulated in additional paid-in capital should be based on the excess tax benefits that are recorded in additional paid-in capital after adoption of the fair value based method and that relate only to awards accounted for under the fair value based method. Although only a few respondents addressed that decision, those respondents generally agreed with the Board's decision, and it was affirmed during redeliberations. As a result of that decision, under either the prospective method or the modified prospective method, no excess tax benefits from the exercise of awards accounted for under the fair value based method will be accumulated in additional paid-in capital as of the beginning of the period of initial application.

Prominence of Disclosures

A17. During the Board's deliberations leading to the Exposure Draft, a number of users of financial statements raised concerns about the consistency and comparability of reported results arising from the choice between the intrinsic value method and the fair value based method of accounting for stock-based employee compensation. The Board decided to address those concerns in the context of this limited-scope project by improving the required disclosures about the effects on reported results of accounting policy decisions related to stock-based employee compensation.

A18. The Board considered whether the pro forma disclosures required by paragraph 45 of Statement 123 should be presented on the face of the income statement. The Board considered existing FASB literature and other financial reporting guidance governing pro forma financial information (for example, the rules and regulations of securities regulators) and the proliferation of "pro forma" language in various public reports of financial performance. The Exposure Draft reflected the Board's decision not to require disclosure of the Statement 123 pro forma amounts on the face of the income statement. The Board noted that all financial statement disclosures required under generally accepted accounting principles are integral to the financial statements and necessary for a proper understanding of reported results, financial position, and cash flows.

A19. However, in the deliberations leading to the Exposure Draft, the Board acknowledged constituents' concerns about the possible lack of comparability and concluded that all companies should be required to provide comparable information about stock-based employee compensation cost. Although the Board continues to believe that disclosure is not an adequate substitute for recognition of items that qualify for recognition in financial statements, the Board believes that the disclosures required by this Statement will mitigate the disadvantages of permitting multiple transition methods by providing information to enable users of financial statements to make comparisons among entities while a choice between intrinsic value and fair value continues to exist. Therefore, the Exposure Draft reflected the Board's decision that the disclosures required by paragraph 2(e) of this Statement should be included in the financial statements of all entities that cover periods in which all or a portion of the cost of stock-based awards was determined under Opinion 25.

A20. Also, during the deliberations leading to the Exposure Draft, the Board observed that the effects of some stock-based compensation arrangements accounted for under Opinion 25 continue to appear in the financial statements of companies that voluntarily adopt the fair value recognition provisions of Statement 123. The Exposure Draft reflected the Board's decision that the disclosure requirements of paragraphs 2(e) and 3 of this Statement should, therefore, apply to those companies as well until the fair value based method applies to all stock-based employee compensation that affects all periods presented. However, entities that elect the retroactive restatement method will have no need to provide those pro forma disclosures. Respondents generally agreed that the required disclosures, overall, represent an improvement over the existing requirements, and the Board affirmed that decision during redeliberations.

A21. Because the disclosures required by paragraph 2(e) are intended to provide information to enable users of financial statements to make comparisons among companies, the Exposure Draft reflected the Board's conclusion that those disclosures should be displayed prominently. Specifically, the Board decided to require (a) that those disclosures be presented in the "Summary of Significant Accounting Policies" or its equivalent and (b) that the pro forma information be disclosed in tabular form. The Board acknowledged, however, that some companies may not have adopted the preferable method of disclosing accounting policies as expressed in paragraph 15 of APB Opinion No. 22, *Disclosure of Accounting Policies,* which states:

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

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

A22. Respondents generally agreed with the Board's decision to require a tabular presentation of the pro forma disclosures. However, a number of respondents stated that the tabular, quantitative disclosures required by this Statement are inconsistent with the narrative, descriptive, or qualitative disclosures contemplated by Opinion 22 and that it is highly unusual for the Board to prescribe a specific format and location for financial statement disclosures. The Board believes, however, that as long as the choice between the intrinsic value method and the fair value based method continues to exist, the decision about which accounting method to apply to stock-based employee compensation has a material, permanent effect on reported results for many companies. Therefore, that particular accounting policy decision warrants amplification through quantification in the "Summary of Significant Accounting Policies" or its equivalent. That accounting policy decision is further distinguished from most other accounting policy decisions that generally affect the timing of recognition of revenues or expenses because it permanently includes or excludes an item from the determination of income. Therefore, the Board affirmed its decision to require tabular presentation of the pro forma information in the "Summary of Significant Accounting Policies" or its equivalent.

Interim Disclosures

A23. Paragraph 106 of Statement 123 states, in part:

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

Based on concerns expressed by investors and creditors and on research demonstrating the importance of interim financial reporting to timely decision making by investors, the Exposure Draft reflected the Board's conclusion that the pro forma disclosures required under Statement 123 should be provided on a quarterly basis. Although quarterly financial information is not required to, and generally does not, include a "Summary of Significant Accounting Policies," the Board decided that the pro forma information required by this Statement should be disclosed prominently in financial reports containing condensed financial statements for interim periods.

A24. Respondents generally agreed with the Board's decision to require more frequent disclosures of the effects of stock-based employee compensation, and the Board affirmed that decision during redeliberations.

Effective Dates

A25. The Exposure Draft reflected the Board's decision that the alternative transition methods permitted by this Statement should be effective for fiscal years ending after December 15, 2002, with earlier application permitted to the extent that, upon issuance of this Statement, a company has not already issued annual financial statements reflecting this change in accounting. Because one objective of this Statement is to respond to the concerns of preparers about the lack of consistency arising from the ramp-up effect, the Board concluded that immediate availability of this guidance and the transition methods it allows is appropriate. Respondents generally agreed with that decision, and the Board affirmed it during redeliberations.

A26. The Exposure Draft proposed that the annual disclosures required by this Statement be effective for financial statements for fiscal years ending after December 15, 2002. The Board believes that those disclosures are important to financial statement users and that the data needed to make those disclosures are readily available to preparers. Earlier application is encouraged for entities with fiscal years that end prior to December 16, 2002, but that upon issuance of this Statement, have not yet issued financial statements for the 2002 fiscal year. Respondents generally agreed with that decision, and the Board affirmed it during redeliberations.

A27. The Exposure Draft reflected the Board's decision that the disclosure provisions for interim financial information would be effective for all periods presented in financial reports containing condensed financial statements for interim periods beginning after December 15, 2002. The Board considered the incremental cost of providing those disclosures and concluded that the benefit of those disclosures to investors and creditors outweighs that cost. Respondents generally agreed with that decision, and the Board affirmed it during redeliberations.

Appendix B: ILLUSTRATIVE GUIDANCE

Transition Provisions

B1. The following illustrations provide examples of how to determine the transition effect (described in paragraph 2(c) of this Statement) arising at the beginning of the period of initial application of the fair value based method of accounting for stock-based employee compensation. One example illustrates the retroactive restatement method, and the other illustrates the modified prospective method. The retroactive restatement example also illustrates the accounting for forfeitures in periods subsequent to adoption as well as the impact of recognized deferred tax assets upon exercise of the awards.

Illustration 1—Fixed Stock Option Award: Retroactive Restatement Method

B2. On January 1, 1999, ABC Company grants its employees options to purchase 100,000 shares of ABC Company common stock at $10 per share, the market price on January 1, 1999. All of the options vest five years from the grant date. ABC Company elects to adopt the fair value based method of accounting for stock-based employee compensation on January 1, 2003. ABC Company elects the retroactive restatement method of transition. The earliest year for which an income statement will be presented in ABC Company's 2003 financial statements is 2001, and ABC Company elects not to restate earlier periods. Because the intrinsic value of the awards was zero at the grant date (also the measurement date in this case) no compensation cost or deferred tax benefit was recognized by ABC Company related to those awards under Opinion 25.

B3. The fair value of the stock options on the grant date was \$6 per share, or \$600,000. Had ABC Company applied the fair value based method from the grant date, it would have recognized the following amounts related to the January 1, 1999 grant as of January 1, 2001, the date of initial application of the fair value based method:

	1999	**2000**
Compensation cost	\$120,000	\$120,000
Deferred tax benefit @ 50%	\$60,000	\$60,000

When ABC Company adopts the fair value based method, it will record the following adjustment to the beginning balances as of January 1, 2001:

Deferred tax asset	120,000	
Additional paid-in capital		120,000

Because ABC Company elected not to restate periods prior to 2001, the transition effect is determined as of the beginning of 2001 and is reported as an adjustment to additional paid-in capital pursuant to the requirements of this Statement. If ABC Company had elected to restate earlier periods, the transition effect would be determined as of the beginning of the period of initial application, and the effect on retained earnings of restating subsequent periods would have been reported as an adjustment to retained earnings as of the beginning of 2001.

B4. ABC Company will then restate its reported results for 2001 and 2002 to reflect the compensation cost determined under the fair value based method of \$120,000 in each period, with a corresponding increase to additional paid-in capital. In addition, ABC Company will record the deferred tax benefit of \$60,000 each year, with a corresponding increase in the deferred tax asset of \$60,000.

Forfeitures

B5. For its previous pro forma disclosures under Statement 123 and upon adoption of the recognition provisions of that Statement, ABC Company followed an accounting policy of recognizing employee forfeitures as they occur, and no compensation cost was capitalized as part of the cost of producing inventory or other self-produced assets. During the first quarter of 2003, ABC Company's stock price declines to \$2. Twenty-five percent of the work force leaves to pursue more attractive employment opportunities, and another 25 percent is terminated in connection with a strategic reorganization. For purposes of this illustration, no forfeitures occurred prior to January 1, 2003. To account for the forfeiture of the related awards, ABC Company records the following journal entries:

Additional paid-in capital	240,000	
Deferred tax expense	120,000	
Deferred tax asset		120,000
Compensation expense		240,000

Under the provisions of this Statement, 50 percent of the $480,000 ($240,000) of cumulative compensation expense that would have been recognized had the recognition provisions of Statement 123 been applied from its original effective date is reversed during the period even though only $120,000 (50 percent of the $240,000 in cumulative cost recognized in 2001 and 2002) of that amount was recognized cumulatively in income.

Tax Effects

B6. In 2005, ABC Company's stock price increases to $12 per share, and all of the outstanding options are exercised. Based on the exercise date intrinsic value of $2 per share, ABC Company realizes an aggregate tax deduction of $100,000 and a tax benefit of $50,000. On a cumulative basis, ABC Company had recognized a deferred tax asset of $150,000. The $100,000 excess deferred tax asset that is not realized is recognized as tax expense during 2005 because ABC Company has no accumulated "excess tax benefits" in additional paid-in capital from prior stock option exercises. For purposes of this illustration, no employee options were exercised subsequent to January 1, 2001, that both (a) were accounted for under the fair value based method and (b) resulted in a tax benefit upon exercise that was greater than the previously recognized deferred tax asset.

Illustration 2—Stock Appreciation Rights: Modified Prospective Method

B7. XYZ Company granted stock appreciation rights (SARs) to certain employees on January 1, 2001, based on 100,000 shares. The stated price of $10 per share was equal to the fair market value of the stock on that date. The SARs provide the employees with the right to receive, at the date the rights are exercised, shares having a then-current market value equal to the market appreciation since the grant date. The employees do not have the ability to receive a cash payment. All of the rights vest at the end of three years and must be exercised no later than the end of the fifth year. XYZ Company uses a calendar year for financial reporting purposes and elects on January 1, 2003, to adopt the fair value based method for recognizing stock-based employee compensation cost. XYZ Company elects the modified prospective method of transition.

B8. The underlying stock price, compensation cost recognized, and related deferred tax benefit recognized under the intrinsic value method of Opinion 25 are as follows:

	2001	2002
Stock price at December 31	$12	$14
Compensation cost	$66,667	$200,000

Deferred tax benefit @ 50%	$33,333	$100,000

As of December 31, 2002, XYZ Company has recognized a deferred tax asset of $133,333 and has increased additional paid-in capital by $266,667.

B9. The fair value of the SAR on the grant date was $2.10 per share, or $210,000. Had XYZ Company applied the fair value based method from the grant date it would have recognized the following amounts related to the January 1, 2001 grant:

	2001	**2002**
Compensation cost	$70,000	$70,000
Deferred tax benefit @ 50%	$35,000	$35,000

Under the fair value based method, XYZ Company would have recognized a deferred tax asset at December 31, 2002, of $70,000 and an increase in additional paid-in capital of $140,000.

B10. As of January 1, 2003, when XYZ Company adopts the fair value based method, it will record the following transition adjustment:

Additional paid-in capital	63,333	
Deferred tax asset		63,333

Because this Statement requires that the transition effect be recorded as an adjustment to additional paid-in capital rather than retained earnings, the net reduction in additional paid-in capital in the entry above reflects the change in net assets arising from transition. To the extent that contra-equity balances had been recorded related to an entity's stock-based compensation arrangements, those balances also would be charged against additional paid-in capital. Under paragraph 30 of Statement 123, neither deferred (prepaid) compensation (a contra-equity account) nor additional paid-in capital is recognized on the grant date. Additional paid-in capital is increased as compensation cost is recognized.

Disclosure Provisions

B11. The following illustrations provide examples of the disclosures required under paragraphs 2(e) and 3 of this Statement. Three examples illustrate the disclosures required under the various transition methods permitted under this Statement, one example illustrates the amended disclosures required for a company that continues to apply the Opinion 25 intrinsic value method, and one example illustrates the disclosures required by this Statement in financial reports for interim periods.

B12. The disclosures required by paragraphs 46–48 of Statement 123 are unaffected by this Statement. Examples of the disclosures required under those paragraphs are provided in

Appendix B of Statement 123.

Illustration 3—Prospective Method

B13. The following disclosures for the financial statements for the year ended December 31, 2003, assume that the company has adopted in 2002 the fair value based method of accounting for stock-based employee compensation using the prospective method of transition. For simplicity, this illustration also assumes that all previous awards were fixed stock options with no intrinsic value at the date of grant.

> At December 31, 2003, the company has four stock-based employee compensation plans, which are described more fully in Note XX. [4] Prior to 2002, the company accounted for those plans under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and related Interpretations. No stock-based employee compensation cost is reflected in 2001 net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Effective January 1, 2002, the company adopted the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation,* prospectively to all employee awards granted, modified, or settled after January 1, 2002. Awards under the company's plans vest over periods ranging from three to five years. Therefore, the cost related to stock-based employee compensation included in the determination of net income for 2002 and 2003 is less than that which would have been recognized if the fair value based method had been applied to all awards since the original effective date of Statement 123. The following table illustrates the effect on net income and earnings per share if the fair value based method had been applied to all outstanding and unvested awards in each period.

	Year Ended December 31		
	2003	**2002**	**2001**
Net income, as reported	$ 471,387	$ 404,113	$ 347,790
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	7,913	3,187	—
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, [5] net of related tax effects	(18,902)	(12,747)	(10,962)
Pro forma net income	$ 460,398	$ 394,553	$ 336,828
Earnings per share:			

Basic—as reported	$2.62	$2.27	$1.97
Basic—pro forma	$2.56	$2.22	$1.91
Diluted—as reported	$1.99	$1.72	$1.49
Diluted—pro forma	$1.94	$1.68	$1.44

Illustration 4—Modified Prospective Method

B14. The following disclosures for the financial statements for the year ended December 31, 2003, assume that the company has adopted in 2003 the fair value based method of accounting for stock-based employee compensation using the modified prospective method of transition. For simplicity, this illustration also assumes that all previous awards were fixed stock options with no intrinsic value at the date of grant.

> At December 31, 2003, the company has four stock-based employee compensation plans, which are described more fully in Note XX. Prior to 2003, the company accounted for those plans under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and related Interpretations. No stock-based employee compensation cost was reflected in 2001 or 2002 net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Effective January 1, 2003, the company adopted the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. Under the modified prospective method of adoption selected by the company under the provisions of FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure,* compensation cost recognized in 2003 is the same as that which would have been recognized had the recognition provisions of Statement 123 been applied from its original effective date. Results for prior years have not been restated. The following table illustrates the effect on net income and earnings per share if the fair value based method had been applied to all outstanding and unvested awards in each period.

	Year Ended December 31		
	2003	**2002**	**2001**
Net income, as reported	$ 460,398	$ 407,300	$ 347,790
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	18,902	—	—

Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards,[6] net of related tax effects	(18,902)	(12,747)	(10,962)
Pro forma net income	$ 460,398	$ 394,553	$ 336,828
Earnings per share:			
Basic—as reported	$2.56	$2.29	$1.97
Basic—pro forma	$2.56	$2.22	$1.91
Diluted—as reported	$1.94	$1.73	$1.49
Diluted—pro forma	$1.94	$1.68	$1.44

Illustration 5—Retroactive Restatement

B15. The following disclosures for the financial statements for the year ended December 31, 2003, assume that the company has adopted in 2003 the fair value based method of accounting for stock-based employee compensation using the retroactive restatement method of transition. For simplicity, this illustration also assumes that all previous awards were fixed stock options with no intrinsic value at the date of grant.

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

Illustration 6—Continued Accounting under Opinion 25

B16. The following disclosures for the financial statements for the year ended December 31, 2003, assume that the company continues to account for stock-based employee compensation using the intrinsic value method under Opinion 25. For simplicity, this illustration also assumes that all previous awards were fixed stock options with no intrinsic value at the date of grant.

> At December 31, 2003, the company has four stock-based employee compensation plans, which are described more fully in Note XX. The company accounts for those plans

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

	Year Ended December 31		
	2003	**2002**	**2001**
Net income, as reported	$ 479,300	$ 407,300	$ 347,790
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, [7] net of related tax effects	(18,902)	(12,747)	(10,962)
Pro forma net income	$ 460,398	$ 394,553	$ 336,828
Earnings per share:			
Basic—as reported	$2.66	$2.29	$1.97
Basic—pro forma	$2.56	$2.22	$1.91
Diluted—as reported	$2.02	$1.73	$1.49
Diluted—pro forma	$1.94	$1.68	$1.44

Illustration 7—Interim Disclosures

B17. The following disclosures for the interim financial information for the three-month and nine-month periods ended June 30, 2003, assume that during the third quarter of its fiscal 2003, a company with a September 30 year-end adopts the fair value based method of accounting for stock-based employee compensation as of the beginning of fiscal 2003 using the modified prospective method of transition. For simplicity, this illustration also assumes that all previous awards were fixed stock options with no intrinsic value at the date of grant.

During the third quarter of fiscal 2003, the company adopted the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation,* for stock-based employee compensation, effective as of the beginning of the fiscal year. Under the modified prospective method of adoption selected by the company, stock-based employee compensation cost recognized in 2003 is the same as that which would have been recognized had the fair value recognition provisions of Statement 123 been applied to all awards granted after October 1, 1995. The following table illustrates the effect on net income and earnings per share as if the fair value based method had been applied to all outstanding and unvested awards in each period.

	3 Months Ended June 30		9 Months Ended June 30	
	2003	**2002**	**2003**	**2002**
Net income, as reported	$ 115,100	$ 101,825	$ 345,299	$ 305,475
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	4,725	—	14,177	—
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, [8] net of related tax effects	(4,725)	(3,187)	(14,177)	(9,560)
Pro forma net income	$ 115,100	$ 98,638	$ 345,299	$ 295,915
Earnings per share:				
Basic—as reported	$0.64	$0.57	$1.92	$1.72
Basic—pro forma	$0.64	$0.55	$1.92	$1.66
Diluted—as reported	$0.49	$0.43	$1.45	$1.29
Diluted—pro forma	$0.49	$0.42	$1.45	$1.25

Footnotes

FAS148, Par. 2(e) Footnote *—APB Opinion No. 22, *Disclosure of Accounting Policies,* paragraph 15, introduces the term *Summary of Significant Accounting Policies* and expresses a preference for disclosure of accounting policies preceding the notes to financial statements or as the initial note.

FAS148, Par. 2(e) Footnote †—For purposes of applying the guidance in this Statement, *all awards* refers to awards granted, modified, or settled in fiscal periods beginning after December 15, 1994—that is, awards for which the grant date fair value was required to be measured under this Statement.

FAS148, Par. 2(f) Footnote *—For purposes of applying the guidance in this subparagraph, *all awards* refers to awards granted, modified, or settled in fiscal periods beginning after December 15, 1994—that is, awards for which the grant date fair value was required to be measured under FASB Statement No. 123, *Accounting for Stock-Based Compensation*.

FAS148 Footnote 1--As Statement 123, paragraph 269, states, "Some respondents were concerned about the inherent 'ramp-up' effect on compensation cost as additional awards are granted and the first awards to which the new method applies move through their vesting periods."

FAS148 Footnote 2--Statement 123, paragraph 270, states, "The Board recognizes the potential for misleading implications caused by the ramp-up effect of prospective application of a new accounting or pro forma disclosure requirement for a recurring transaction. . . . The Board decided that requiring retroactive application would be excessively burdensome."

FAS148 Footnote 3—For purposes of the discussion in the basis for conclusions, *new awards* refers to awards granted, modified, or settled in periods subsequent to adoption of the fair value based method of Statement 123.

FAS148 Footnote 4--Note XX would include the disclosures required by paragraphs 46–48 of Statement 123.

FAS148 Footnote 5--*All awards* refers to awards granted, modified, or settled in fiscal periods beginning after December 15, 1994—that is, awards for which the fair value was required to be measured under Statement 123.

FAS148 Footnote 6--Refer to footnote 5 to this Statement.

FAS148 Footnote 7--Refer to footnote 5 to this Statement.

FAS148 Footnote 8--Refer to footnote 5 to this Statement.