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STATUS REPORT
No. 237

Financial Accounting Standards Board
of the Financial Accounting Foundation

PROJECT UPDATE-STOCK COMPENSATION

Earlier this year, the Board tentatively agreed that compensation expense arising from both fixed and performance based stock compensation plans should be measured as the fair value of the option or other stock-based award at the grant date. The estimated value at the grant date would be subsequently adjusted, if necessary, to reflect the outcome of both performance conditions and service-related factors. No compensation expense would be recognized for options that do not vest—whether those options are forfeited upon termination of service or not earned because of failure to meet performance targets. The estimated actual life of an option (from grant date to exercise date) would be used rather than its stated term to determine the fair value of the option; the life would be subsequently adjusted as necessary based on actual experience.

The Board also tentatively concluded that the fair value of employee stock options generally should be estimated using a method, such as an option-pricing model, that takes into account the exercise price and expected term of the option, the current price of the underlying stock, expected dividends on the stock and its expected volatility, and the expected risk-free rate of return during the term of the option. Because nonpublic companies have no information about the volatility of their stock on which to base an estimate of expected future volatility, the Board agreed that nonpublic companies may estimate the value of employee stock options using a method that omits that factor.

Board members decided that the guidance on how to determine the fair value of employee stock options should be general in that one model or method, such as Black-Scholes, would not be specified. The method used and the weighted averages of both the fair values and the exercise prices of options granted during the year would be disclosed.

Option Pricing Models

Some are concerned that option-pricing models may be too difficult both to apply and to understand. The FASB staff has found that reasonably priced and "user friendly" software for personal computers is available. Most currently available valuation software is sold as "add-ins" to spreadsheet software such as Lotus 1-2-3 or Microsoft Excel. Anyone familiar with spreadsheet software will find them easy to use. For example, the staff has been using "Options XL Premium," a Microsoft Excel add-in for option pricing, sensitivity analysis, and risk management. We are **grateful to Montgomery Investment Group of Wayne, Pennsylvania for donating the software to the FASB.**