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Statement of Financial Accounting Standards No. 123 (revised 2004)

Share-Based Payment

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of the Financial Accounting Foundation

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Summary

This Statement is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation.* This Statement supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and its related implementation guidance.

Scope of This Statement

This Statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. This Statement does not change the accounting guidance for share-based payment transactions with parties other than employees provided in Statement 123 as originally issued and 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." This Statement does not address the accounting for employee share ownership plans, which are subject to AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans.*

Reasons for Issuing This Statement

The principal reasons for issuing this Statement are:

a. **Addressing concerns of users and others.** Users of financial statements, including institutional and individual investors, as well as many other parties expressed to the FASB their concerns that using Opinion 25's intrinsic value method results in financial statements that do not faithfully represent the economic transactions affecting the issuer, namely, the receipt and consumption of employee services in exchange for equity instruments. Financial statements that do not faithfully represent those economic transactions can distort the issuer's reported financial condition and results of operations, which can lead to the inappropriate allocation of resources in the capital markets. Part of the FASB's mission is to improve standards of financial accounting for the benefit of users of financial information. This Statement addresses users' and other parties' concerns by requiring an entity to recognize the cost of employee services received in share-based payment transactions, thereby reflecting the economic consequences of those transactions in the financial statements.

b. **Improving the comparability of reported financial information by eliminating alternative accounting methods.** Over the last few years, approximately 750 public companies have voluntarily adopted or announced their intention to adopt Statement 123's fair-value-based method of accounting for share-based payment transactions with employees. Other companies continue to use Opinion 25's intrinsic value method. The Board believes that similar economic transactions should be accounted for similarly (that is, share-based compensation transactions with employees should be accounted for using one method). Consistent with the conclusion in the original Statement 123, the Board believes that those transactions should be accounted for using a fair-value-based method. By requiring the fair-value-based method for all public entities, this Statement eliminates an alternative accounting method; consequently, similar economic transactions will be accounted for similarly.
c. **Simplifying U.S. GAAP.** The Board believes that U.S. generally accepted accounting principles (GAAP) should be simplified whenever possible. Requiring that all entities follow the same accounting standard and eliminating Opinion 25's intrinsic value method and its related detailed and form-driven implementation guidance simplifies the authoritative literature.
d. **Converging with international accounting standards.** This Statement will result in greater international comparability in the accounting for share-based payment transactions. In February 2004, the International Accounting Standards Board (IASB), whose standards are followed by entities in many countries, issued International Financial Reporting Standard (IFRS) 2, *Share-based Payment.* IFRS 2 requires that all entities recognize an expense for all employee services received in share-based payment transactions, using a fair-value-based method that is similar in most respects to the fair-value-based method established in Statement 123 and the improvements made to it by this Statement. Converging to a common set of high-quality financial accounting standards for share-based payment transactions with employees improves the comparability of financial information around the world and makes the accounting requirements for entities that report financial statements under both U.S. GAAP and international accounting standards less burdensome.

Key Provisions of This Statement

This Statement requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award—the requisite service period (usually the vesting period). No compensation cost is recognized for equity instruments for which employees do not render the requisite

service. Employee share purchase plans will not result in recognition of compensation cost if certain conditions are met; those conditions are much the same as the related conditions in Statement 123.

A nonpublic entity, likewise, will measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of those instruments, except in certain circumstances. Specifically, if it is not possible to reasonably estimate the fair value of equity share options and similar instruments because it is not practicable to estimate the expected volatility of the entity's share price, a nonpublic entity is required to measure its awards of equity share options and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of its share price.

A public entity will initially measure the cost of employee services received in exchange for an award of liability instruments based on its current fair value; the fair value of that award will be remeasured subsequently at each reporting date through the settlement date. Changes in fair value during the requisite service period will be recognized as compensation cost over that period. A nonpublic entity may elect to measure its liability awards at their intrinsic value through the date of settlement.

The grant-date fair value of employee share options and similar instruments will be estimated using option-pricing models adjusted for the unique characteristics of those instruments (unless observable market prices for the same or similar instruments are available). If an equity award is modified after the grant date, incremental compensation cost will be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately before the modification.

Excess tax benefits, as defined by this Statement, will be recognized as an addition to paid-in capital. Cash retained as a result of those excess tax benefits will be presented in the statement of cash flows as financing cash inflows. The write-off of deferred tax assets relating to unrealized tax benefits associated with recognized compensation cost will be recognized as income tax expense unless there are excess tax benefits from previous awards remaining in paid-in capital to which it can be offset.

The notes to financial statements of both public and nonpublic entities will disclose information to assist users of financial information to understand the nature of share-based payment transactions and the effects of those transactions on the financial statements.

How This Statement Changes Practice and Improves Financial Reporting

This Statement eliminates the alternative to use Opinion 25's intrinsic value method of accounting that was provided in Statement 123 as originally issued. Under Opinion 25, issuing stock options to employees generally resulted in recognition of no compensation cost. This Statement requires entities to recognize the cost of employee

services received in exchange for awards of equity instruments based on the grant-date fair value of those awards (with limited exceptions). Recognition of that compensation cost helps users of financial statements to better understand the economic transactions affecting an entity and to make better resource allocation decisions. Such information specifically will help users of financial statements understand the effect that share-based compensation transactions have on an entity's financial condition and results of operations. This Statement also will improve comparability by eliminating one of two different methods of accounting for share-based compensation transactions and thereby also will simplify existing U.S. GAAP. Eliminating different methods of accounting for the same transactions leads to improved comparability of financial statements because similar economic transactions will be accounted for similarly.

The fair-value-based method in this Statement is similar to the fair-value-based method in Statement 123 in most respects. However, the following are the key differences between the two:

a. Public entities are required to measure liabilities incurred to employees in share-based payment transactions at fair value. Nonpublic entities may elect to measure their liabilities to employees incurred in share-based payment transactions at their intrinsic value. Under Statement 123, all share-based payment liabilities were measured at their intrinsic value.
b. Nonpublic entities are required to account for awards of equity instruments using the fair-value-based method unless it is not possible to reasonably estimate the grant-date fair value of awards of equity share options and similar instruments because it is not practicable to estimate the expected volatility of the entity's share price. In that situation, the entity will account for those instruments based on a value calculated by substituting the historical volatility of an appropriate industry sector index for the expected volatility of its share price. Statement 123 permitted a nonpublic entity to measure its equity awards using either the fair-value-based method or the minimum value method.
c. Entities are required to estimate the number of instruments for which the requisite service is expected to be rendered. Statement 123 permitted entities to account for forfeitures as they occur.
d. Incremental compensation cost for a modification of the terms or conditions of an award is measured by comparing the fair value of the modified award with the fair value of the award immediately before the modification. Statement 123 required that the effects of a modification be measured as the difference between the fair value of the modified award at the date it is granted and the award's value immediately before the modification determined based on the shorter of (1) its remaining initially estimated expected life or (2) the expected life of the modified award.

e. This Statement also clarifies and expands Statement 123's guidance in several areas, including measuring fair value, classifying an award as equity or as a liability, and attributing compensation cost to reporting periods.

In addition, this Statement amends FASB Statement No. 95, *Statement of Cash Flows,* to require that excess tax benefits be reported as a financing cash inflow rather than as a reduction of taxes paid.

How the Conclusions of This Statement Relate to the FASB's Conceptual Framework

FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises,* states that financial reporting should provide information that is useful in making business and economic decisions. Recognizing compensation cost incurred as a result of receiving employee services in exchange for valuable equity instruments issued by the employer will help achieve that objective by providing more relevant and reliable information about the costs incurred by the employer to obtain employee services in the marketplace.

FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information,* explains that comparability of financial information is important because information about an entity gains greatly in usefulness if it can be compared with similar information about other entities. Establishing the fair-value-based method of accounting as the required method will increase comparability because similar economic transactions will be accounted for similarly, which will improve the usefulness of financial information. Requiring the fair-value-based method also enhances the neutrality of the resulting financial reporting by eliminating the accounting bias toward using certain types of employee share options for compensation.

Completeness is identified in Concepts Statement 2 as an essential element of representational faithfulness and relevance. To faithfully represent the total cost of employee services to the entity, the cost of services received in exchange for awards of share-based compensation should be recognized in that entity's financial statements.

FASB Concepts Statement No. 6, *Elements of Financial Statements,* defines *assets* as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. Employee services received in exchange for awards of share-based compensation qualify as assets, though only momentarily—as the entity receives and uses them—although their use may create or add value to other assets of the entity. This Statement will improve the accounting for an entity's assets resulting from receipt of employee services in exchange for an equity award by requiring that the cost of such assets either be charged to expense when consumed or capitalized as part of another asset of the entity (as permitted by U.S. GAAP).

Costs and Benefits

The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. The Board's consideration of each issue in a project includes the subjective weighing of the incremental improvement in financial reporting against the incremental cost of implementing the identified alternatives. At the end of that process, the Board considers the accounting provisions in the aggregate and assesses the perceived benefits and the related perceived costs on a qualitative basis.

Several procedures were conducted before the issuance of this Statement to aid the Board in its assessment of the expected costs associated with implementing the required use of the fair-value-based accounting method. Those procedures included a review of the comment letters received on the Exposure Draft, a field visit program, a survey of commercial software providers, and discussions with members of the Option Valuation Group that the Board established to provide information and advice on how to improve the guidance in Statement 123 on measuring the fair value of share options and similar instruments issued to employees in compensation arrangements. That group included valuation experts from the compensation consulting, risk management, investment banking, and academic communities. The Board also discussed the issues in the project with other valuation experts, compensation consultants, and numerous other constituents. After considering the results of those cost-benefit procedures, the Board concluded that this Statement will sufficiently improve financial reporting to justify the costs it will impose.

The Effective Dates and Transition Requirements of This Statement

This Statement is effective:

a. For public entities that do not file as small business issuers—as of the beginning of the first interim or annual reporting period that begins after June 15, 2005
b. For public entities that file as small business issuers—as of the beginning of the first interim or annual reporting period that begins after December 15, 2005
c. For nonpublic entities—as of the beginning of the first annual reporting period that begins after December 15, 2005.

This Statement applies to all awards granted after the required effective date and to awards modified, repurchased, or cancelled after that date. The cumulative effect of initially applying this Statement, if any, is recognized as of the required effective date.

As of the required effective date, all public entities and those nonpublic entities that used the fair-value-based method for either recognition or disclosure under Statement 123 will apply this Statement using a modified version of prospective application. Under that transition method, compensation cost is recognized on or after the required effective date for the portion of outstanding awards for which the requisite service has not yet been rendered, based on the grant-date fair value of those awards calculated under Statement 123 for either recognition or pro forma disclosures. For periods before the required effective date, those entities may elect to apply a modified version of retrospective application under which financial statements for prior periods are adjusted on a basis consistent with the pro forma disclosures required for those periods by Statement 123. Nonpublic entities that used the minimum value method in Statement 123 for either recognition or pro forma disclosures are required to apply the prospective transition method as of the required effective date.

Early adoption of this Statement for interim or annual periods for which financial statements or interim reports have not been issued is encouraged.

Statement of Financial Accounting Standards No. 123

(revised 2004)

Share-Based Payment

December 2004

Financial Accounting Standards Board
of the Financial Accounting Foundation
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INTRODUCTION

1. This Statement requires that the cost resulting from all **share-based payment transactions**[1] be recognized in the financial statements. This Statement establishes **fair value** as the measurement objective in accounting for **share-based payment arrangements** and requires all entities to apply a fair-value-based measurement method in accounting for share-based payment transactions with **employees** except for equity instruments held by **employee share ownership plans.** However, this Statement provides certain exceptions to that measurement method if it is not possible to reasonably estimate the fair value of an award at the **grant date.** A **nonpublic entity** also may choose to measure its liabilities under share-based payment arrangements at **intrinsic value.** This Statement also establishes fair value as the measurement objective for transactions in which an entity acquires goods or services from nonemployees in share-based payment transactions. This Statement uses the terms *compensation* and *payment* in their broadest senses to refer to the consideration paid for goods or services, regardless of whether the supplier is an employee.

2. This Statement amends FASB Statement No. 95, *Statement of Cash Flows,* to require that **excess tax benefits** be reported as a financing cash inflow rather than as a reduction of taxes paid.

3. This Statement replaces FASB Statement No. 123, *Accounting for Stock-Based Compensation,* and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. This Statement also supersedes or amends other pronouncements indicated in Appendix D. Appendix A is an integral part of this Statement and provides implementation guidance on measurement and recognition of compensation cost resulting from share-based payment arrangements with employees. Appendix B provides the basis for the Board's conclusions, and Appendix C provides background information. Appendix E defines certain terms as they are used in this Statement, and Appendix F indicates the effect of this Statement on the status of related authoritative literature, including American Institute of Certified Public Accountants (AICPA) literature, Emerging Issues Task Force (EITF) issues, and Statement 133 implementation issues.

[1]Terms defined in Appendix E, the glossary, are set in **boldface type** the first time they appear.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope

4. This Statement applies to all share-based payment transactions in which an entity acquires goods or services by **issuing** (or offering to issue) its shares, **share options,** or other equity instruments (except for equity instruments held by an employee share ownership plan)[2] or by incurring liabilities to an employee or other supplier (a) in amounts based, at least in part,[3] on the price of the entity's shares or other equity instruments or (b) that require or may require **settlement** by issuing the entity's equity shares or other equity instruments.

Recognition Principle for Share-Based Payment Transactions

5. An entity shall recognize the goods acquired or services received in a share-based payment transaction when it obtains the goods or as services are received.[4] The entity shall recognize either a corresponding increase in equity or a liability, depending on whether the instruments granted satisfy the equity or liability classification criteria (paragraphs 28–35). As the goods or services are disposed of or consumed, the entity shall recognize the related cost. For example, when inventory is sold, the cost is recognized in the income statement as cost of goods sold, and as services are consumed, the cost usually is recognized in determining net income of that period, for example, as expenses incurred for employee services. In some circumstances, the cost of services (or goods) may be initially capitalized as part of the cost to acquire or construct another asset, such as inventory, and later recognized in the income statement when that asset is disposed of or consumed.[5]

6. The accounting for all share-based payment transactions shall reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of

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[2]AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans,* specifies the accounting by employers for employee share ownership plans.

[3]The phrase *at least in part* is used because an award of share-based compensation may be indexed to both the price of an entity's shares and something else that is neither the price of the entity's shares nor a market, performance, or service condition.

[4]An entity may need to recognize an asset before it actually receives goods or services if it first exchanges share-based payment for an enforceable right to receive those goods or services. Nevertheless, the goods or services themselves are not recognized before they are received.

[5]This Statement refers to recognizing *compensation cost* rather than *compensation expense* because any compensation cost that is capitalized as part of the cost to acquire or construct an asset would not be recognized as compensation expense in the income statement.

the instruments, regardless of how those transactions are structured. For example, the rights and obligations embodied in a transfer of equity shares to an employee for a note that provides no recourse to other assets of the employee (that is, other than the shares) are substantially the same as those embodied in a grant of equity share options. Thus, that transaction shall be accounted for as a substantive grant of equity share options. The **terms** of a share-based payment award and any related arrangement affect its value and, except for certain explicitly excluded features, such as a **reload feature,** shall be reflected in determining the fair value of the equity or liability instruments granted. For example, the fair value of a substantive option structured as the exchange of equity shares for a nonrecourse note will differ depending on whether the employee is required to pay nonrefundable interest on the note. Assessment of both the rights and obligations in a share-based payment award and any related arrangement and how those rights and obligations affect the fair value of an award requires the exercise of judgment in considering the relevant facts and circumstances.

Measurement Principle for Share-Based Payment Transactions

7. If the fair value of goods or services received in a share-based payment transaction with nonemployees is more reliably measurable than the fair value of the equity instruments issued, the fair value of the goods or services received shall be used to measure the transaction.[6] In contrast, if the fair value of the equity instruments issued in a share-based payment transaction with nonemployees is more reliably measurable than the fair value of the consideration received, the transaction shall be measured based on the fair value of the equity instruments issued. A share-based payment transaction with employees shall be measured based on the fair value (or in certain situations specified in this Statement, a **calculated value** or intrinsic value) of the equity instruments issued.

Measurement Date for Share-Based Payment Transactions with Nonemployees

8. This Statement does not specify the **measurement date** for share-based payment transactions with nonemployees for which the measure of the cost of goods acquired or services received is based on the fair value of the equity instruments issued. 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,"

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[6] The consideration received for issuing equity instruments, like the consideration involved in a repurchase of treasury shares, may include stated or unstated rights. FASB Technical Bulletin No. 85-6, *Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending against a Takeover Attempt,* provides pertinent guidance.

establishes criteria for determining the measurement date for equity instruments issued in share-based payment transactions with nonemployees.

Accounting for Share-Based Payment Transactions with Employees

9. The objective of accounting for transactions under share-based payment arrangements with employees is to recognize in the financial statements the employee services received in exchange for equity instruments issued or liabilities incurred and the related cost to the entity as those services are consumed.

10. An entity shall account for the compensation cost from share-based payment transactions with employees in accordance with the fair-value-based method set forth in paragraphs 11–63 of this Statement. That is, the cost of services received from employees in exchange for awards[7] of share-based compensation generally shall be measured based on the grant-date fair value of the equity instruments issued or on the fair value of the liabilities incurred. The fair value of liabilities incurred in share-based transactions with employees shall be remeasured at the end of each reporting period through settlement. Paragraphs 23–25 and 38 set forth exceptions to the fair-value-based measurement of awards of share-based employee compensation.

Certain Transactions with Related Parties and Other Economic Interest Holders

11. Share-based payments awarded to an employee of the reporting entity by a **related party** or other holder of an **economic interest** in the entity as compensation for services provided to the entity are share-based payment transactions to be accounted for under this Statement unless the transfer is clearly for a purpose other than compensation for services to the reporting entity. The substance of such a transaction is that the economic interest holder makes a capital contribution to the reporting entity, and that entity makes a share-based payment to its employee in exchange for services rendered. An example of a situation in which such a transfer is not compensation is a transfer to settle an obligation of the economic interest holder to the employee that is unrelated to employment by the entity.

[7]This Statement uses the term *award* as the collective noun for multiple instruments with the same terms and conditions granted at the same time either to a single employee or to a group of employees. An award may specify multiple vesting dates, referred to as graded vesting, and different parts of an award may have different expected terms. Provisions of this Statement that refer to *an award* also apply to a portion of an award.

Employee Share Purchase Plans

12. An employee share purchase plan that satisfies all of the following criteria does not give rise to recognizable compensation cost (that is, the plan is noncompensatory):

a. The plan satisfies at least one of the following conditions:
   (1) The terms of the plan are no more favorable than those available to all holders of the same class of shares.[8]
   (2) Any purchase discount from the market price does not exceed the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering. A purchase discount of 5 percent or less from the market price shall be considered to comply with this condition without further justification. A purchase discount greater than 5 percent that cannot be justified under this condition results in compensation cost for the entire amount of the discount.[9]
b. Substantially all employees that meet limited employment qualifications may participate on an equitable basis.
c. The plan incorporates no option features, other than the following:
   (1) Employees are permitted a short period of time—not exceeding 31 days—after the purchase price has been fixed to enroll in the plan.
   (2) The purchase price is based solely on the market price of the shares at the date of purchase, and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid (such as those paid by payroll withholdings).

13. A plan provision that establishes the purchase price as an amount based on the lesser of the equity share's market price at date of grant or its market price at date of purchase is an example of an option feature that causes the plan to be compensatory. Similarly, a plan in which the purchase price is based on the share's market price at date of grant and that permits a participating employee to cancel participation before the purchase date and obtain a refund of amounts previously paid contains an option feature that causes the plan to be compensatory. Illustrations 19 (paragraphs A211–A219)

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[8]A transaction subject to an employee share purchase plan that involves a class of equity shares designed exclusively for and held only by current or former employees or their beneficiaries may be compensatory depending on the terms of the arrangement.

[9]An entity that justifies a purchase discount in excess of 5 percent shall reassess at least annually, and no later than the first share purchase offer during the fiscal year, whether it can continue to justify that discount pursuant to paragraph 12(a)(2) of this Statement.

and 20 (paragraphs A220 and A221) provide guidance on determining whether an employee share purchase plan satisfies the criteria necessary to be considered noncompensatory.

14. The **requisite service period** for any compensation cost resulting from an employee share purchase plan is the period over which the employee participates in the plan and pays for the shares.

Measurement Principle for Share-Based Payment Transactions with Employees

15. The cost of services received by an entity as consideration for equity instruments issued or liabilities incurred in share-based compensation transactions with employees shall be measured based on the fair value of the equity instruments issued or the liabilities settled. The portion of the fair value of an instrument attributed to employee service is net of any amount that an employee pays (or becomes obligated to pay) for that instrument when it is granted. For example, if an employee pays $5 at the grant date for an option with a grant-date fair value of $50, the amount attributed to employee service is $45.

Measurement of Awards Classified as Equity

Measurement Objective and Measurement Date for Equity Awards

16. The measurement objective for equity instruments awarded to employees is to estimate the fair value at the grant date of the equity instruments that the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments (for example, to exercise share options). That estimate is based on the share price and other pertinent factors, such as expected **volatility,** at the grant date.

17. To satisfy the measurement objective in paragraph 16, the **restrictions** and conditions inherent in equity instruments awarded to employees are treated differently depending on whether they continue in effect after the requisite service period. A restriction that continues in effect after an entity has issued instruments to employees, such as the inability to transfer **vested** equity share options to third parties or the inability to sell vested shares for a period of time, is considered in estimating the fair value of the instruments at the grant date. For equity share options and similar instruments, the effect of nontransferability (and nonhedgeability, which has a similar effect) is taken into account by reflecting the effects of employees' expected exercise and post-vesting employment termination behavior in estimating fair value (referred to as an option's *expected term*).

18. In contrast, a restriction that stems from the forfeitability of instruments to which employees have not yet earned the right, such as the inability either to exercise a nonvested equity share option or to sell **nonvested shares,** is not reflected in estimating the fair value of the related instruments at the grant date. Instead, those restrictions are taken into account by recognizing compensation cost only for awards for which employees render the requisite service.

19. Awards of share-based employee compensation ordinarily specify a **performance condition** or a **service condition** (or both) that must be satisfied for an employee to earn the right to benefit from the award. No compensation cost is recognized for instruments that employees forfeit because a service condition or a performance condition is not satisfied (that is, instruments for which the requisite service is not rendered). Some awards contain a **market condition.** The effect of a market condition is reflected in the grant-date fair value of an award.[10] Compensation cost thus is recognized for an award with a market condition provided that the requisite service is rendered, regardless of when, if ever, the market condition is satisfied. Illustrations 4 (paragraphs A86–A104), 5 (paragraphs A105–A110), and 10 (paragraphs A127–A133) provide examples of how compensation cost is recognized for awards with service and performance conditions.

20. The fair-value-based method described in paragraphs 16–19 uses fair value measurement techniques, and the grant-date share price and other pertinent factors are used in applying those techniques. However, the effects on the grant-date fair value of service and performance conditions that apply only during the requisite service period are reflected based on the outcomes of those conditions. The remainder of this Statement refers to the required measure as fair value.

Nonvested and Restricted Equity Shares

21. A nonvested equity share or nonvested equity **share unit** awarded to an employee shall be measured at its fair value as if it were vested and issued on the grant date. A **restricted share**[11] awarded to an employee, that is, a share that will be restricted after the employee has a vested right to it, shall be measured at its fair value, which is the same amount for which a similarly restricted share would be issued to third parties. Illustration 11(a) (paragraphs A134–A136) provides an example of accounting for an award of nonvested shares.

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[10]Valuation techniques have been developed to value path-dependent options as well as other options with complex terms. Awards with market conditions, as defined in this Statement, are path-dependent options.

[11]Nonvested shares granted to employees usually are referred to as *restricted shares,* but this Statement reserves that term for fully vested and outstanding shares whose sale is contractually or governmentally prohibited for a specified period of time.

Equity Share Options

22. The fair value of an equity share option or similar instrument shall be measured based on the observable market price of an option with the same or similar terms and conditions, if one is available (paragraph A7).[12] Otherwise, the fair value of an equity share option or similar instrument shall be estimated using a valuation technique such as an option-pricing model. For this purpose, a *similar instrument* is one whose fair value differs from its intrinsic value, that is, an instrument that has **time value.** For example, a share appreciation right (SAR) that requires net settlement in equity shares has time value; an equity share does not. Paragraphs A2–A42 provide additional guidance on estimating the fair value of equity instruments, including the factors to be taken into account in estimating the fair value of equity share options or similar instruments as described in paragraph A18.

Equity Instruments for Which It Is Not Possible to Reasonably Estimate Fair Value at the Grant Date

Equity instruments granted by a nonpublic entity for which it is not possible to reasonably estimate fair value at the grant date because it is not practicable to estimate the expected volatility of the entity's share price

23. A nonpublic entity may not be able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price. In that situation, the entity shall account for its equity share options and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of the entity's share price (the calculated value).[13] Paragraphs A43–A48 and Illustration 11(b) (paragraphs A137–A142) provide additional guidance on applying the calculated value method to equity share options and similar instruments granted by a nonpublic entity.

Equity instruments with terms that make it not possible to reasonably estimate fair value at the grant date

24. It should be possible to reasonably estimate the fair value of most equity share options and other equity instruments at the date they are granted. Appendix A illustrates techniques for estimating the fair values of several instruments with complicated

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[12]As of the issuance of this Statement, such market prices for equity share options and similar instruments granted to employees are generally not available; however, they may become so in the future.

[13]Throughout the remainder of this Statement, provisions that apply to accounting for share options and similar instruments at fair value also apply to calculated value.

features. However, in rare circumstances, it may not be possible to reasonably estimate the fair value of an equity share option or other equity instrument at the grant date because of the complexity of its terms.

25. An equity instrument for which it is not possible to reasonably estimate fair value at the grant date shall be accounted for based on its intrinsic value, remeasured at each reporting date through the date of exercise or other settlement. The final measure of compensation cost shall be the intrinsic value of the instrument at the date it is settled. Compensation cost for each period until settlement shall be based on the change (or a portion of the change, depending on the percentage of the requisite service that has been rendered at the reporting date) in the intrinsic value of the instrument in each reporting period. The entity shall continue to use the intrinsic value method for those instruments even if it subsequently concludes that it is possible to reasonably estimate their fair value.

Reload Options and Contingent Features

26. The fair value of each award of equity instruments, including an award of options with a reload feature (reload options), shall be measured separately based on its terms and the share price and other pertinent factors at the grant date. The effect of a reload feature in the terms of an award shall not be included in estimating the grant-date fair value of the award. Rather, a subsequent grant of reload options pursuant to that provision shall be accounted for as a separate award when the reload options are granted.

27. A contingent feature of an award that might cause an employee to return to the entity either equity instruments earned or realized gains from the sale of equity instruments earned for consideration that is less than fair value on the date of transfer (including no consideration), such as a clawback feature (paragraph A5, footnote 44), shall not be reflected in estimating the grant-date fair value of an equity instrument. Instead, the effect of such a contingent feature shall be accounted for if and when the contingent event occurs.

Awards Classified as Liabilities

Criteria for Classifying Awards as Liabilities

28. Paragraphs 29–35 of this Statement provide guidance for determining whether certain financial instruments awarded in share-based payment transactions are liabilities. In determining whether an instrument not specifically discussed in paragraphs 29–35 should be classified as a liability or as equity, an entity shall apply generally accepted accounting principles (GAAP) applicable to financial instruments issued in transactions not involving share-based payment.

Applying the classification criteria in Statement 150

29. FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,* excludes from its scope instruments that are accounted for under this Statement. Nevertheless, unless paragraphs 30–35 of this Statement require otherwise, an entity shall apply the classification criteria in paragraphs 8–14 of Statement 150, as they are effective at the reporting date, in determining whether to classify as a liability a **freestanding financial instrument** given to an employee in a share-based payment transaction. Paragraphs A230–A232 of this Statement provide criteria for determining when instruments subject to this Statement subsequently become subject to Statement 150 or to other applicable GAAP.

30. In determining the classification of an instrument, an entity shall take into account the deferrals contained in FSP FAS 150-3, "Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*." In addition, a call option[14] written on an instrument that is not classified as a liability because of the deferrals in FSP FAS 150-3 (for example, a call option on a mandatorily redeemable share for which liability classification is deferred under FSP FAS 150-3) also shall be classified as equity while the deferral is in effect unless liability classification is required under the provisions of paragraph 32 of this Statement.

Classification of certain awards with repurchase features

31. Statement 150 does not apply to outstanding shares embodying a conditional obligation to transfer assets, for example, shares that give the employee the right to require the employer to repurchase them for cash equal to their fair value (puttable shares). A puttable (or callable) share[15] awarded to an employee as compensation shall be classified as a liability if either of the following conditions is met: (a) the repurchase feature permits the employee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time from the date the

[14]Refer to the definition of *share option* in Appendix E.

[15]A put right may be granted to the employee in a transaction that is related to a share-based compensation arrangement. If exercise of such a put right would require the entity to repurchase shares issued under the share-based compensation arrangement, the shares shall be accounted for as puttable shares.

requisite service is rendered and the share is issued,[16,17] or (b) it is probable that the employer would prevent the employee from bearing those risks and rewards for a reasonable period of time from the date the share is issued. For this purpose, a period of six months or more is a *reasonable period of time*. A puttable (or callable) share that does not meet either of those conditions shall be classified as equity.[18]

32. Options or similar instruments on shares shall be classified as liabilities if (a) the underlying shares are classified as liabilities or (b) the entity can be required under any circumstances to settle the option or similar instrument by transferring cash or other assets. For example, an entity may grant an option to an employee that, upon exercise, would be settled by issuing a mandatorily redeemable share that is not subject to the deferral in FSP FAS 150-3. Because the mandatorily redeemable share would be classified as a liability under Statement 150, the option also would be classified as a liability.

Awards with conditions other than market, performance, or service conditions

33. An award may be indexed to a factor in addition to the entity's share price. If that additional factor is not a market, performance, or service condition, the award shall be classified as a liability for purposes of this Statement, and the additional factor shall be reflected in estimating the fair value of the award.[19] Paragraph A53 provides examples of such awards.

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[16]A repurchase feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control (such as an initial public offering) would not meet condition (a) until it becomes probable that the event will occur within the reasonable period of time.

[17]An employee begins to bear the risks and rewards normally associated with equity share ownership when all the requisite service has been rendered.

[18]SEC registrants are required to consider the guidance in ASR No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks."* Under that guidance, shares subject to mandatory redemption requirements or whose redemption is outside the control of the issuer are classified outside permanent equity.

[19]For this purpose, an award of equity share options granted to an employee of an entity's foreign operation that provides for a fixed exercise price denominated either in the foreign operation's functional currency or in the currency in which the employee's pay is denominated shall not be considered to contain a condition that is not a market, performance, or service condition. Therefore, such an award is not required to be classified as a liability if it otherwise qualifies as equity. For example, equity share options with an exercise price denominated in Euros granted to employees of a U.S. entity's foreign operation whose functional currency is the Euro are not required to be classified as liabilities if those options otherwise qualify as equity. In addition, such options are not required to be classified as liabilities even if the functional currency of the foreign operation is the U.S. dollar, provided that the employees to whom the options are granted are paid in Euros.

Evaluating the terms of a share-based payment award in determining whether it qualifies as a liability

34. The accounting for an award of share-based payment shall reflect the substantive terms of the award and any related arrangement. Generally, the written terms provide the best evidence of the substantive terms of an award. However, an entity's past practice may indicate that the substantive terms of an award differ from its written terms. For example, an entity that grants a **tandem award** under which an employee receives either a stock option or a cash-settled SAR is obligated to pay cash on demand if the choice is the employee's, and the entity thus incurs a liability to the employee. In contrast, if the choice is the entity's, it can avoid transferring its assets by choosing to settle in stock, and the award qualifies as an equity instrument. However, if an entity that nominally has the choice of settling awards by issuing stock predominately settles in cash, or if the entity usually settles in cash whenever an employee asks for cash settlement, the entity is settling a substantive liability rather than repurchasing an equity instrument. In determining whether an entity that has the choice of settling an award by issuing equity shares has a substantive liability, the entity also shall consider whether (a) it has the ability to deliver the shares[20] and (b) it is required to pay cash if a contingent event occurs (paragraph 32).

Broker-assisted cashless exercises and minimum statutory withholding requirements

35. A provision that permits employees to effect a **broker-assisted cashless exercise** of part or all of an award of share options through a broker does not result in liability classification for instruments that otherwise would be classified as equity if both of the following criteria are satisfied:[21]

a. The cashless exercise requires a valid exercise of the share options.
b. The employee is the legal owner of the shares subject to the option (even though the employee has not paid the exercise price before the sale of the shares subject to the option).

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[20]Federal securities law generally requires that transactions involving offerings of shares under employee share option arrangements be registered, unless there is an available exemption. For purposes of this Statement, such requirements do not, by themselves, imply that an entity does not have the ability to deliver shares and thus do not require an award that otherwise qualifies as equity to be classified as a liability.

[21]A broker that is a related party of the entity must sell the shares in the open market within a normal settlement period, which generally is three days, for the award to qualify as equity.

Similarly, a provision for either direct or indirect (through a net-settlement feature) repurchase of shares issued upon exercise of options (or the vesting of nonvested shares), with any payment due employees withheld to meet the employer's minimum statutory withholding requirements[22] resulting from the exercise, does not, by itself, result in liability classification of instruments that otherwise would be classified as equity. However, if an amount in excess of the minimum statutory requirement is withheld, or may be withheld at the employee's discretion, the entire award shall be classified and accounted for as a liability.

Measurement Objective and Measurement Date for Liabilities

36. At the grant date, the measurement objective for liabilities incurred under share-based compensation arrangements is the same as the measurement objective for equity instruments awarded to employees as described in paragraph 16. However, the measurement date for liability instruments is the date of settlement. Accordingly, liabilities incurred under share-based payment arrangements are remeasured at the end of each reporting period until settlement.

Measurement of liability awards of public entities

37. A **public entity** shall measure a liability award under a share-based payment arrangement based on the award's fair value remeasured at each reporting date until the date of settlement. Compensation cost for each period until settlement shall be based on the change (or a portion of the change, depending on the percentage of the requisite service that has been rendered at the reporting date) in the fair value of the instrument for each reporting period. Illustration 10 (paragraphs A127–A133) provides an example of accounting for an instrument classified as a liability using the fair-value-based method.

Measurement of liability awards of nonpublic entities

38. A nonpublic entity shall make a policy decision of whether to measure all of its liabilities incurred under share-based payment arrangements at fair value or to measure

[22]Minimum statutory withholding requirements are to be based on the applicable minimum statutory withholding rates required by the relevant tax authority (or authorities, for example, federal, state, and local), including the employee's share of payroll taxes that are applicable to such supplemental taxable income.

all such liabilities at intrinsic value.[23] Regardless of the method selected, a nonpublic entity shall remeasure its liabilities under share-based payment arrangements at each reporting date until the date of settlement. The fair-value-based method is preferable for purposes of justifying a change in accounting principle under APB Opinion No. 20, *Accounting Changes*. Illustration 10 (paragraphs A127–A133) provides an example of accounting for an instrument classified as a liability using the fair-value-based method. Illustration 11(c) (paragraphs A143–A148) provides an example of accounting for an instrument classified as a liability using the intrinsic value method.

Recognition of Compensation Cost for an Award Accounted for as an Equity Instrument

Recognition of Compensation Cost over the Requisite Service Period

39. The compensation cost for an award of share-based employee compensation classified as equity shall be recognized over the requisite service period, with a corresponding credit to equity (generally, paid-in capital). The requisite service period is the period during which an employee is required to provide service in exchange for an award, which often is the vesting period. The requisite service period is estimated based on an analysis of the terms of the share-based payment award.

40. The requisite service period may be explicit or it may be implicit, being inferred from an analysis of other terms in the award, including other explicit service or performance conditions. The requisite service period for an award that contains a market condition can be derived from certain valuation techniques that may be used to estimate grant-date fair value (paragraph A60). An award may have one or more **explicit, implicit,** or **derived service periods;** however, an award may have only one requisite service period for accounting purposes unless it is accounted for as in-substance multiple awards.[24] Paragraphs A59–A74 provide guidance on estimating the requisite service period and provide examples of how that period should be estimated if an award's terms include more than one explicit, implicit, or derived service period.

41. The **service inception date** is the beginning of the requisite service period. If the service inception date precedes the grant date (paragraph A79), accrual of compensa-

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[23]Consistent with the guidance in paragraph 23, footnote 13, a nonpublic entity that is not able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price shall make a policy choice of whether to measure its liabilities under share-based payment arrangements at calculated value or at intrinsic value.

[24]An award with a graded vesting schedule that is accounted for as in-substance multiple awards is an example of an award that has more than one requisite service period (paragraph 42).

tion cost for periods before the grant date shall be based on the fair value of the award at the reporting date. In the period in which the grant date occurs, cumulative compensation cost shall be adjusted to reflect the cumulative effect of measuring compensation cost based on fair value at the grant date rather than the fair value previously used at the service inception date (or any subsequent reporting date). Illustration 3 (paragraphs A79–A85) provides guidance on the concept of *service inception date* and how it is to be applied.

42. An entity shall make a policy decision about whether to recognize compensation cost for an award with only service conditions that has a graded vesting schedule (a) on a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in-substance, multiple awards or (b) on a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award). However, the amount of compensation cost recognized at any date must at least equal the portion of the grant-date value of the award that is vested at that date. Illustration 4(b) (paragraphs A97–A104) provides an example of the accounting for an award with a graded vesting schedule.

Amount of Compensation Cost to Be Recognized over the Requisite Service Period

43. The total amount of compensation cost recognized at the end of the requisite service period for an award of share-based compensation shall be based on the number of instruments for which the requisite service has been rendered (that is, for which the requisite service period has been completed). An entity shall base initial accruals of compensation cost on the estimated number of instruments for which the requisite service is expected to be rendered. That estimate shall be revised if subsequent information indicates that the actual number of instruments is likely to differ from previous estimates. The cumulative effect on current and prior periods of a change in the estimated number of instruments for which the requisite service is expected to be or has been rendered shall be recognized in compensation cost in the period of the change.

44. Accruals of compensation cost for an award with a performance condition shall be based on the probable[25] outcome of that performance condition—compensation cost shall be accrued if it is probable that the performance condition will be achieved and shall not be accrued if it is not probable that the performance condition will be achieved. If an award has multiple performance conditions (for example, if the number

[25]*Probable* is used in the same sense as in FASB Statement No. 5, *Accounting for Contingencies:* "the future event or events are likely to occur" (paragraph 3).

of options or shares an employee earns varies depending on which, if any, of two or more performance conditions is satisfied), compensation cost shall be accrued if it is probable that a performance condition will be satisfied. In making that assessment, it may be necessary to take into account the interrelationship of those performance conditions. Illustration 5 (paragraphs A105–A110) provides an example of how to account for awards with multiple performance conditions.

45. Previously recognized compensation cost shall not be reversed if an employee share option (or share unit) for which the requisite service has been rendered expires unexercised (or unconverted).

Estimating the Requisite Service Period

46. An entity shall make its initial best estimate of the requisite service period at the grant date (or at the service inception date if that date precedes the grant date) and shall base accruals of compensation cost on that period. An entity shall adjust that initial best estimate in light of changes in facts and circumstances. The initial best estimate and any subsequent adjustment to that estimate of the requisite service period for an award with a combination of market, performance, or service conditions shall be based on an analysis of (a) all vesting and exercisability conditions, (b) all explicit, implicit, and derived service periods, and (c) the probability that performance or service conditions will be satisfied. For such an award, whether and how the initial best estimate of the requisite service period is adjusted depends on both the nature of those conditions and the manner in which they are combined, for example, whether an award vests or becomes exercisable when either a market or a performance condition is satisfied or whether both conditions must be satisfied. Paragraphs A59–A66 provide guidance on adjusting the initial estimate of the requisite service period.

Effect of Market, Performance, and Service Conditions on Recognition and Measurement of Compensation Cost

Market, performance, and service conditions that affect vesting or exercisability

47. If an award requires satisfaction of one or more market, performance, or service conditions (or any combination thereof), compensation cost is recognized if the requisite service is rendered, and no compensation cost is recognized if the requisite service is not rendered. Paragraphs A49–A51 provide guidance on applying this provision to awards with market, performance, or service conditions (or any combination thereof).

48. Performance or service conditions that affect vesting are not reflected in estimating the fair value of an award at the grant date because those conditions are restrictions that stem from the forfeitability of instruments to which employees have not yet earned the right. However, the effect of a market condition is reflected in estimating the fair value of an award at the grant date (paragraph 19). For purposes of this Statement, a market condition is not considered to be a vesting condition, and an award is not deemed to be forfeited solely because a market condition is not satisfied. Accordingly, an entity shall reverse previously recognized compensation cost for an award with a market condition only if the requisite service is not rendered.

Market, performance, and service conditions that affect factors other than vesting or exercisability

49. Market, performance, and service conditions (or any combination thereof) may affect an award's exercise price, contractual term, quantity, conversion ratio, or other factors that are considered in measuring an award's grant-date fair value. A grant-date fair value shall be estimated for each possible outcome of such a performance or service condition, and the final measure of compensation cost shall be based on the amount estimated at the grant date for the condition or outcome that is actually satisfied. Paragraphs A52–A54 provide additional guidance on the effects of market, performance, and service conditions that affect factors other than vesting or exercisability. Illustrations 5 (paragraphs A105–A110), 6 (paragraphs A111–A113), and 8 (paragraphs A121–A124) provide examples of accounting for awards with such conditions.

Recognition of Changes in the Fair Value or Intrinsic Value of Awards Classified as Liabilities

50. Changes in the fair value (or intrinsic value for a nonpublic entity that elects that method) of a liability incurred under a share-based payment arrangement that occur during the requisite service period shall be recognized as compensation cost over that period. The percentage of the fair value (or intrinsic value) that is accrued as compensation cost at the end of each period shall equal the percentage of the requisite service that has been rendered at that date. Changes in the fair value (or intrinsic value) of a liability that occur after the end of the requisite service period are compensation cost of the period in which the changes occur. Any difference between the amount for which a liability award is settled and its fair value at the settlement date as estimated in accordance with the provisions of this Statement is an adjustment of compensation cost in the period of settlement. Illustration 10 (paragraphs A127–A133) provides an example of accounting for a liability award from the grant date through its settlement.

Modifications of Awards of Equity Instruments

51. A **modification** of the terms or conditions of an equity award shall be treated as an exchange of the original award for a new award.[26] In substance, the entity repurchases the original instrument by issuing a new instrument of equal or greater value, incurring additional compensation cost for any incremental value. The effects of a modification shall be measured as follows:

a. Incremental compensation cost shall be measured as the excess, if any, of the fair value of the modified award determined in accordance with the provisions of this Statement over the fair value of the original award immediately before its terms are modified, measured based on the share price and other pertinent factors at that date.[27] The effect of the modification on the number of instruments expected to vest also shall be reflected in determining incremental compensation cost. The estimate at the modification date of the portion of the award expected to vest shall be subsequently adjusted, if necessary, in accordance with paragraphs 43–45 and other guidance in Illustration 13 (paragraphs A160–A170).
b. Total recognized compensation cost for an equity award shall at least equal the fair value of the award at the grant date unless at the date of the modification the performance or service conditions of the original award are not expected to be satisfied. Thus, the total compensation cost measured at the date of a modification shall be (1) the portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date plus (2) the incremental cost resulting from the modification. Compensation cost shall be subsequently adjusted, if necessary, in accordance with paragraphs 43–45 and other guidance in Illustration 13 (paragraphs A160–A170).
c. A change in compensation cost for an equity award measured at intrinsic value in accordance with paragraph 25 shall be measured by comparing the intrinsic value of the modified award, if any, with the intrinsic value of the original award, if any, immediately before the modification.

Illustrations 12–14 (paragraphs A149–A189) provide additional guidance on, and illustrate the accounting for, modifications of both vested and nonvested awards, including a modification that changes the classification of the related financial

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[26]A modification of a liability award also is accounted for as the exchange of the original award for a new award. However, because liability awards are remeasured at their fair value (or intrinsic value for a nonpublic entity that elects that method) at each reporting date, no special guidance is necessary in accounting for a modification of a liability award that remains a liability after the modification.

[27]As indicated in paragraph 23, footnote 13, references to *fair value* throughout paragraphs 24–85 of this Statement should be read also to encompass *calculated value*.

instruments from equity to liability or vice versa, and modifications of vesting conditions. Illustration 22 (paragraphs A225–A232) provides additional guidance on accounting for modifications of certain freestanding financial instruments that initially were subject to this Statement but subsequently became subject to other applicable GAAP.

Inducements

52. A **short-term inducement** shall be accounted for as a modification of the terms of only the awards of employees who accept the inducement. Other inducements are modifications of the terms of all awards subject to them and shall be accounted for as such.

Equity Restructurings

53. Exchanges of share options or other equity instruments or changes to their terms in conjunction with an **equity restructuring** or a business combination are modifications for purposes of this Statement.

54. Except for a modification to add an antidilution provision that is not made in contemplation of an equity restructuring, accounting for a modification in conjunction with an equity restructuring requires a comparison of the fair value of the modified award with the fair value of the original award immediately before the modification in accordance with paragraph 51. If those amounts are the same, for instance, because the modification is designed to equalize the fair value of an award before and after an equity restructuring, no incremental compensation cost is recognized. Illustration 12(e) (paragraphs A156–A159) provides further guidance on applying the provisions of this paragraph.

Repurchases or Cancellations of Awards of Equity Instruments

55. The amount of cash or other assets transferred (or liabilities incurred) to repurchase an equity award shall be charged to equity, to the extent that the amount paid does not exceed the fair value of the equity instruments repurchased at the repurchase date. Any excess of the repurchase price over the fair value of the instruments repurchased shall be recognized as additional compensation cost. An entity that repurchases an award for which the requisite service has not been rendered has, in effect, modified the requisite service period to the period for which service already has been rendered, and thus the amount of compensation cost measured at the grant date but not yet recognized shall be recognized at the repurchase date.

Cancellation and Replacement of Awards of Equity Instruments

56. Cancellation of an award accompanied by the concurrent grant of (or offer to grant)[28] a **replacement award** or other valuable consideration shall be accounted for as a modification of the terms of the cancelled award. Therefore, incremental compensation cost shall be measured as the excess of the fair value of the replacement award or other valuable consideration over the fair value of the cancelled award at the cancellation date in accordance with paragraph 51. Thus, the total compensation cost measured at the date of a cancellation and replacement shall be the portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date plus the incremental cost resulting from the cancellation and replacement.

57. A cancellation of an award that is not accompanied by the concurrent grant of (or offer to grant) a replacement award or other valuable consideration shall be accounted for as a repurchase for no consideration. Accordingly, any previously unrecognized compensation cost shall be recognized at the cancellation date.

Accounting for Tax Effects of Share-Based Compensation Awards

58. Income tax regulations specify allowable tax deductions for instruments issued under share-based payment arrangements in determining an entity's income tax liability. For example, under U.S. tax law at the issuance date of this Statement, allowable tax deductions are generally measured as the intrinsic value of an instrument on a specified date. The time value component, if any, of the fair value of an instrument generally is not tax deductible. Therefore, tax deductions generally will arise in different amounts and in different periods from compensation cost recognized in financial statements.

59. The cumulative amount of compensation cost recognized for instruments classified as equity that ordinarily would result in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference in applying FASB Statement No. 109, *Accounting for Income Taxes*. The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes. The deferred tax benefit (or expense) that results from increases (or decreases) in that temporary difference, for example, an increase that results as additional service is rendered and the related cost is recognized or a decrease that results from forfeiture of

[28]The phrase *offer to grant* is intended to cover situations in which the service inception date precedes the grant date.

an award, shall be recognized in the income statement.[29] Recognition of compensation cost for instruments that ordinarily do not result in tax deductions under existing tax law shall not be considered to result in a deductible temporary difference in applying Statement 109. A future event, such as an employee's disqualifying disposition of shares under U.S. tax law at the issuance date of this Statement, can give rise to a tax deduction for instruments that ordinarily do not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs.

60. The cumulative amount of compensation cost recognized for instruments classified as liabilities that ordinarily would result in a future tax deduction under existing tax law also shall be considered to be a deductible temporary difference. The deductible temporary difference shall be based on the compensation cost recognized for financial reporting purposes.

61. Statement 109 requires a deferred tax asset to be evaluated for future realization and to be reduced by a valuation allowance if, based on the weight of the available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized.[30] Differences between (a) the deductible temporary difference computed pursuant to paragraph 59 of this Statement and (b) the tax deduction that would result based on the current fair value of the entity's shares shall not be considered in measuring the gross deferred tax asset or determining the need for a valuation allowance for a deferred tax asset recognized under this Statement.

62. If a deduction reported on a tax return for an award of equity instruments exceeds the cumulative compensation cost for those instruments recognized for financial reporting, any resulting realized tax benefit that exceeds the previously recognized deferred tax asset for those instruments (the excess tax benefit) shall be recognized as additional paid-in capital.[31] However, an excess of a realized tax benefit for an award over the deferred tax asset for that award shall be recognized in the income statement

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[29]Compensation cost that is capitalized as part of the cost of an asset, such as inventory, shall be considered to be part of the tax basis of that asset for financial reporting purposes.

[30]Paragraph 21 of Statement 109 states, "Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carry-forward period available under the tax law." That paragraph goes on to describe the four sources of taxable income that may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards.

[31]If only a portion of an award is exercised, determination of the excess tax benefits shall be based on the portion of the award that is exercised.

to the extent that the excess stems from a reason other than changes in the fair value of an entity's shares between the measurement date for accounting purposes and a later measurement date for tax purposes.

63. The amount deductible on the employer's tax return may be less than the cumulative compensation cost recognized for financial reporting purposes. The write-off of a deferred tax asset related to that deficiency, net of the related valuation allowance, if any, shall first be offset to the extent of any remaining additional paid-in capital from excess tax benefits from previous awards accounted for in accordance with this Statement or Statement 123. The remaining balance, if any, of the write-off of a deferred tax asset related to a tax deficiency shall be recognized in the income statement. An entity that continued to use Opinion 25's intrinsic value method as permitted by Statement 123 shall calculate the amount available for offset as the net amount of excess tax benefits that would have qualified as such had it instead adopted Statement 123 for recognition purposes pursuant to Statement 123's original effective date and transition method. In determining that amount, no distinction shall be made between excess tax benefits attributable to different types of equity awards, such as restricted shares or share options. An entity shall exclude from that amount both excess tax benefits from share-based payment arrangements that are outside the scope of this Statement, such as employee share ownership plans, and excess tax benefits that have not been realized pursuant to Statement 109, as noted in paragraph A94, footnote 82, of this Statement. Illustrations 4(a) (paragraphs A94–A96), 10 (paragraphs A132 and A133), 11(a) (paragraphs A135 and A136), and 14(a) (paragraphs A178–A180) of this Statement provide examples of accounting for the income tax effects of various awards.

Disclosures

64. An entity with one or more share-based payment arrangements shall disclose information that enables users of the financial statements to understand:

a. The nature and terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders
b. The effect of compensation cost arising from share-based payment arrangements on the income statement
c. The method of estimating the fair value of the goods or services received, or the fair value of the equity instruments granted (or offered to grant), during the period
d. The cash flow effects resulting from share-based payment arrangements.

Paragraphs A240 and A241 indicate the minimum information needed to achieve those objectives and illustrate how the disclosure requirements might be satisfied. In some circumstances, an entity may need to disclose information beyond that listed in paragraph A240 to achieve the disclosure objectives.

65. An entity that acquires goods or services other than employee services in share-based payment transactions shall provide disclosures similar to those required by paragraph 64 to the extent that those disclosures are important to an understanding of the effects of those transactions on the financial statements. In addition, an entity that has multiple share-based payment arrangements with employees shall disclose information separately for different types of awards under those arrangements to the extent that differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of share-based compensation (paragraph A240).

Earnings per Share Implications

66. FASB Statement No. 128, *Earnings per Share,* requires that employee equity share options, nonvested shares, and similar equity instruments granted to employees be treated as potential common shares in computing diluted earnings per share. Diluted earnings per share shall be based on the actual number of options or shares granted and not yet forfeited, unless doing so would be antidilutive. If vesting in or the ability to exercise (or retain) an award is contingent on a performance or market condition, such as the level of future earnings, the shares or share options shall be treated as contingently issuable shares in accordance with paragraphs 30–35 of Statement 128. If equity share options or other equity instruments are outstanding for only part of a period, the shares issuable shall be weighted to reflect the portion of the period during which the equity instruments are outstanding.

67. Paragraphs 21–23 of Statement 128 provide guidance on applying the treasury stock method for equity instruments granted in share-based payment transactions in determining diluted earnings per share.

Amendments to Statement 95

68. Statement 95 is amended by adding the underlined wording as follows:

a. Paragraph 19, as amended by FASB Statements No. 117, *Financial Statements of Not-for-Profit Organizations,* and No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities:*

Cash inflows from financing activities are:

a. Proceeds from issuing equity instruments
b. Proceeds from issuing bonds, mortgages, notes, and from other short- or long-term borrowing
c. Receipts from contributions and investment income that by donor stipulation are restricted for the purposes of acquiring, constructing, or improving property, plant, equipment, or other long-lived assets or establishing or increasing a permanent endowment or term endowment
d. Proceeds received[7a] from derivative instruments that include financing elements[7b] at inception
e. Cash retained as a result of the tax deductibility of increases in the value of equity instruments issued under share-based payment arrangements that are not included in the cost of goods or services that is recognizable for financial reporting purposes. For this purpose, excess tax benefits shall be determined on an individual award (or a portion thereof) basis.

b. Paragraph 23, as amended by FASB Statements No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale,* and No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections:*

Cash outflows for operating activities are:

a. Cash payments to acquire materials for manufacture or goods[8d] for resale, including principal payments on accounts and both short- and long-term notes payable to suppliers for those materials or goods.
b. Cash payments to other suppliers and employees for other goods or services.
c. Cash payments to governments for taxes, duties, fines, and other fees or penalties and the cash that would have been paid for income taxes if increases in the value of equity instruments issued under share-based payment arrangements that are not included in the cost of goods or services recogniz-

able for financial reporting purposes also had not been deductible in determining taxable income. (This is the same amount reported as a financing cash inflow pursuant to paragraph 19(e) of this Statement.)

d. Cash payments to lenders and other creditors for interest.
e. All other cash payments that do not stem from transactions defined as investing or financing activities, such as payments to settle lawsuits, cash contributions to charities, and cash refunds to customers.

c. Paragraph 27, as amended by Statement 117:

In reporting cash flows from operating activities, enterprises are encouraged to report major classes of gross cash receipts and gross cash payments and their arithmetic sum—the net cash flow from operating activities (the direct method). Enterprises that do so should, at a minimum, separately report the following classes of operating cash receipts and payments:[11]

a. Cash collected from customers, including lessees, licensees, and the like
b. Interest and dividends received[11a]
c. Other operating cash receipts, if any
d. Cash paid to employees and other suppliers of goods or services, including suppliers of insurance, advertising, and the like
e. Interest paid
f. Income taxes paid and, separately, the cash that would have been paid for income taxes if increases in the value of equity instruments issued under share-based payment arrangements that are not recognizable as a cost of goods or services for accounting purposes also had not been deductible in determining taxable income (paragraph 19(e))
g. Other operating cash payments, if any.

Enterprises are encouraged to provide further breakdowns of operating cash receipts and payments that they consider meaningful and feasible. For example, a retailer or manufacturer might decide to further divide cash paid to employees and suppliers (category (d) above) into payments for costs of inventory and payments for selling, general, and administrative expenses.

Effective Dates and Transition

69. This Statement is effective:

a. For public entities that do not file as **small business issuers**—as of the beginning of the first interim or annual reporting period that begins after June 15, 2005

b. For public entities that file as small business issuers—as of the beginning of the first interim or annual reporting period that begins after December 15, 2005
c. For nonpublic entities—as of the beginning of the first annual reporting period that begins after December 15, 2005.

The effective date for a nonpublic entity that becomes a public entity after June 15, 2005, and does not file as a small business issuer is the first interim or annual reporting period beginning after the entity becomes a public entity. If the newly public entity files as a small business issuer, the effective date is the first interim or annual reporting period beginning after December 15, 2005, for which the entity is a public entity.

70. This Statement applies to all awards granted after the required effective date. This Statement shall not be applied to awards granted in periods before the required effective date except to the extent that prior periods' awards are modified, repurchased, or cancelled after the required effective date and as required by paragraph 74. The cumulative effect of initially applying this Statement, if any, shall be recognized as of the required effective date (paragraphs 79–82).

71. As of the required effective date, all public entities and those nonpublic entities that used the fair-value-based method for either recognition or disclosure under Statement 123 shall apply the modified prospective application transition method (paragraphs 74 and 75). For periods before the required effective date, those entities may elect to apply the modified retrospective application transition method (paragraphs 76–78).

72. Nonpublic entities that used the minimum value method in Statement 123 for either recognition or pro forma disclosures are required to apply the prospective transition method (paragraph 83) as of the required effective date.

73. Early adoption of this Statement for interim or annual periods for which financial statements or interim reports have not been issued is encouraged.[32]

Modified Prospective Application

74. As of the required effective date, all public entities and those nonpublic entities that used the fair-value-based method for either recognition or disclosure under Statement 123, including such nonpublic entities that become public entities after June 15, 2005, shall adopt this Statement using a modified version of prospective

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[32] If an entity early adopts this Statement pursuant to paragraph 73, then the *required effective date* would be the first date in the initial period of adoption.

application *(modified prospective application).* Under modified prospective application, this Statement applies to new awards and to awards modified, repurchased, or cancelled after the required effective date. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered that are outstanding as of the required effective date shall be recognized as the requisite service is rendered on or after the required effective date. The compensation cost for that portion of awards shall be based on the grant-date fair value of those awards as calculated for either recognition or pro forma disclosures under Statement 123. Changes to the grant-date fair value of equity awards granted before the required effective date of this Statement are precluded.[33] The compensation cost for those earlier awards shall be attributed to periods beginning on or after the required effective date of this Statement using the attribution method that was used under Statement 123, except that the method of recognizing forfeitures only as they occur shall not be continued (paragraph 80). Any unearned or deferred compensation (contra-equity accounts) related to those earlier awards shall be eliminated against the appropriate equity accounts.

75. An entity that does not choose modified retrospective application (paragraphs 76–78 of this Statement) shall apply the amendments to Statement 95 in paragraph 68 of this Statement only for the interim or annual periods for which this Statement is adopted.

Modified Retrospective Application

76. All public entities and those nonpublic entities that used the fair-value-based method for either recognition or disclosure under Statement 123, including such nonpublic entities that become public entities after June 15, 2005, may apply a modified version of retrospective application *(modified retrospective application)* to periods before the required effective date. Modified retrospective application may be applied either (a) to all prior years for which Statement 123 was effective[34] or (b) only to prior interim periods in the year of initial adoption if the required effective date of this Statement does not coincide with the beginning of the entity's fiscal year. An entity that chooses to apply the modified retrospective method to all prior years for which Statement 123 was effective shall adjust financial statements for prior periods to give effect to the fair-value-based method of accounting for awards granted, modified, or settled in cash in fiscal years beginning after December 15, 1994, on a basis consistent

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[33]The prohibition in paragraphs 74 and 76 of changes to the grant-date fair value of equity awards granted before the required effective date of this Statement does not apply if the entity needs to correct an error.

[34]A nonpublic entity shall apply this method to all prior years for which Statement 123's fair-value-based method was adopted for recognition or pro forma disclosures if that date is later than when Statement 123 was first effective.

with the pro forma disclosures required for those periods by Statement 123, as amended by FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure,*[35] and by paragraph 30 of APB Opinion No. 28, *Interim Financial Reporting*. Accordingly, compensation cost and the related tax effects will be recognized in those financial statements as though they had been accounted for under Statement 123.[36] Changes to amounts as originally measured on a pro forma basis are precluded.

77. If an entity applies the modified retrospective application method to all prior years for which Statement 123 was effective and does not present all of those years in comparative financial statements, the beginning balances of paid-in capital, deferred taxes, and retained earnings for the earliest year presented shall be adjusted to reflect the results of modified retrospective application to those prior years not presented. The effects of any such adjustments shall be disclosed in the year of adoption. If an entity applies the modified retrospective application method only to prior interim periods in the year of initial adoption, there would be no adjustment to the beginning balances of paid-in capital, deferred taxes, or retained earnings for the year of initial adoption.

78. The amendments to Statement 95 in paragraph 68 of this Statement shall be applied to the same periods for which the modified retrospective application method is applied.

Transition as of the Required Effective Date for both Modified Prospective and Modified Retrospective Transition Methods

79. Transition as of the required effective date for instruments that are liabilities under the provisions of this Statement shall be as follows:

a. For an instrument that had been classified as equity but is classified as a liability under this Statement, recognize a liability at its fair value (or portion thereof, if the requisite service has not been rendered). If (1) the fair value (or portion therof) of the liability is greater or less than (2) previously recognized compensation cost for the instrument, the liability shall be recognized first, by reducing equity (generally, paid-in capital) to the extent of such previously recognized cost and second, by

[35]For convenience, the remaining discussion in this Statement refers only to *Statement 123*. Those references should be understood as referring to Statement 123, as amended by Statement 148.

[36]This provision applies to all awards regardless of whether they were accounted for as fixed or variable under Opinion 25.

recognizing the difference (that is, the difference between items (1) and (2)) in the income statement, net of any related tax effect, as the cumulative effect of a change in accounting principle.

b. For an outstanding instrument that previously was classified as a liability and measured at intrinsic value, recognize the effect of initially measuring the liability at its fair value, net of any related tax effect, as the cumulative effect of a change in accounting principle.[37]

80. As of the required effective date, an entity that had a policy of recognizing the effect of forfeitures only as they occurred shall estimate the number of outstanding instruments for which the requisite service is not expected to be rendered. Balance sheet amounts related to any compensation cost (excluding nonrefundable dividend payments), net of related tax effects, for those instruments previously recognized in income because of that policy for periods before the effective date of this Statement shall be eliminated and recognized in income as the cumulative effect of a change in accounting principle as of the required effective date.

81. Except as required by paragraph 80, no transition adjustment as of the required effective date shall be made for any deferred tax assets associated with outstanding equity instruments that continue to be accounted for as equity instruments under this Statement. For purposes of calculating the available excess tax benefits if deferred tax assets need to be written off in subsequent periods, an entity shall include as available for offset only the net excess tax benefits that would have qualified as such had the entity adopted Statement 123 for recognition purposes for all awards granted, modified, or settled in cash for fiscal years beginning after December 15, 1994. In determining that amount, an entity shall exclude excess tax benefits that have not been realized pursuant to Statement 109 (paragraph A94, footnote 82, of this Statement). An entity that previously has recognized deferred tax assets for excess tax benefits prior to their realization shall discontinue that practice prospectively and shall follow the guidance in this Statement and in Statement 109.

82. Outstanding equity instruments that are measured at intrinsic value under Statement 123 at the required effective date because it was not possible to reasonably estimate their grant-date fair value shall continue to be measured at intrinsic value until they are settled.

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[37]If share-based compensation cost has been previously capitalized as part of another asset, an entity should consider whether the carrying amount of that asset should be adjusted to reflect amounts calculated pursuant to paragraphs 79(a) and 79(b).

Nonpublic Entities That Used the Minimum Value Method in Statement 123

83. Nonpublic entities, including those that become public entities after June 15, 2005, that used the minimum value method of measuring equity share options and similar instruments for either recognition or pro forma disclosure purposes under Statement 123 shall apply this Statement prospectively to new awards and to awards modified, repurchased, or cancelled after the required effective date. Those entities shall continue to account for any portion of awards outstanding at the date of initial application using the accounting principles originally applied to those awards (either the minimum value method under Statement 123 or the provisions of Opinion 25 and its related interpretive guidance).

Required Disclosures in the Period This Statement Is Adopted

84. In the period that this Statement is adopted, an entity shall disclose the effect of the change from applying the original provisions of Statement 123[38] on income from continuing operations, income before income taxes, net income, cash flow from operations, cash flow from financing activities, and basic and diluted earnings per share. In addition, if awards under share-based payment arrangements with employees are accounted for under the intrinsic value method of Opinion 25 for any reporting period for which an income statement is presented, all public entities shall continue to provide the tabular presentation of the following information that was required by paragraph 45 of Statement 123 for all those periods:

a. Net income and basic and diluted earnings per share as reported
b. The share-based employee compensation cost, net of related tax effects, included in net income as reported
c. The share-based employee compensation cost, net of related tax effects, that would have been included in net income if the fair-value-based method had been applied to all awards[39]
d. Pro forma net income as if the fair-value-based method had been applied to all awards
e. Pro forma basic and diluted earnings per share as if the fair-value-based method had been applied to all awards.

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[38]The effect of the change for the period in which this Statement is adopted will differ depending on whether a public entity had previously adopted the fair-value-based method (or a nonpublic entity had adopted the minimum value method) of Statement 123 or had continued to use the intrinsic value method in Opinion 25.

[39]For paragraphs 84(c)–84(e), *all awards* refers to awards granted, modified, or settled in cash in fiscal periods beginning after December 15, 1994.

The required pro forma amounts shall reflect the difference in share-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 any excess tax benefits credited to additional paid-in capital, were determined under the fair-value-based method.

85. A nonpublic entity that used the minimum value method for pro forma disclosure purposes under the original provisions of Statement 123 shall not continue to provide those pro forma disclosures for outstanding awards accounted for under the intrinsic value method of Opinion 25.

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*
George J. Batavick
G. Michael Crooch
Gary S. Schieneman
Katherine Schipper
Leslie F. Seidman
Edward W. Trott

Appendix A

IMPLEMENTATION GUIDANCE

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Appendix A

IMPLEMENTATION GUIDANCE

INTRODUCTION

A1. This appendix is an integral part of this Statement and provides implementation guidance that illustrates the fair-value-based method of accounting for share-based compensation arrangements with employees. Application of this Statement's provisions to actual situations will require the exercise of judgment; this appendix is intended to aid in making those judgments. Throughout this appendix, the phrase *fair value* is used to describe the measure resulting from the application of this Statement's fair-value-based method.[40]

FAIR VALUE MEASUREMENT OBJECTIVE AND ITS APPLICATION

A2. The measurement objective for equity instruments awarded to employees is to estimate the grant-date fair value of the equity instruments that the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments. That estimate is based on the share price and other pertinent factors (including those enumerated in paragraph A18, if applicable) at the grant date and is not remeasured in subsequent periods under the fair-value-based method.

A3. A restriction[41] that continues in effect after the entity has issued instruments to employees, such as the inability to transfer vested equity share options to third parties or the inability to sell vested shares for a period of time, is considered in estimating the fair value of the instruments at the grant date.[42] For share options and similar instruments, the effect of nontransferability (and nonhedgeability, which has a similar effect) is taken into account by reflecting the effects of employees' expected exercise and post-vesting employment termination behavior in estimating fair value (referred to as an option's *expected term*).

[40]The implementation guidance in this Appendix also applies to nonpublic entities that use the calculated value method pursuant to paragraph 23.

[41]Terms are defined in Appendix E, the glossary.

[42]For instance, if shares are traded in an active market, post-vesting restrictions may have little, if any, effect on the amount at which the shares being valued would be exchanged.

A4. In contrast, a restriction that stems from the forfeitability of instruments to which employees have not yet earned the right, such as the inability either to exercise a nonvested equity share option or to sell nonvested shares is not reflected in the fair value of the instruments at the grant date.[43] Instead, those restrictions are taken into account by recognizing compensation cost only for awards for which employees render the requisite service.

A5. Reload features, and contingent features that require an employee to transfer equity shares earned, or realized gains from the sale of equity instruments earned, to the issuing entity for consideration that is less than fair value on the date of transfer (including no consideration), such as a clawback feature,[44] shall not be reflected in the grant-date fair value of an equity award. Those features are accounted for if and when a reload grant or contingent event occurs.

A6. The fair value measurement objective for liabilities incurred in a share-based payment transaction with employees is the same as for equity instruments awarded to employees. However, awards classified as liabilities are subsequently remeasured to their fair values (or a portion thereof until the requisite service has been rendered) at the end of each reporting period until the liability is settled.

Fair Value of Instruments Granted in a Share-Based Payment Transaction

A7. Fair value is defined in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* as follows:

> The amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. (Concepts Statement 7, Glossary of Terms)

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[43]Performance and service conditions are vesting conditions for purposes of this Statement. Market conditions are not vesting conditions for purposes of this Statement but market conditions may affect exercisability of an award. Market conditions are included in the estimate of the grant-date fair value of awards. Refer to paragraphs A52–A54.

[44]A clawback feature can take various forms but often functions as a noncompete mechanism: for example, an employee that terminates the employment relationship and begins to work for a competitor is required to transfer to the issuing entity (former employer) equity shares granted and earned in a share-based payment transaction.

That definition refers explicitly only to assets and liabilities, but the concept of *value in a current exchange* embodied in it applies equally to the equity instruments subject to this Statement. Observable market prices of identical or similar[45] equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used as the basis for the measurement of equity and liability instruments awarded in a share-based payment transaction with employees. For example, awards to employees of a public entity of shares of its common stock, subject only to a service or performance condition for vesting (nonvested shares), should be measured based on the market price of otherwise identical (that is, identical except for the vesting condition) common stock at the grant date.

A8. If observable market prices of identical or similar equity or liability instruments of the entity are not available,[46] the fair value of equity and liability instruments awarded to employees shall be estimated by using a valuation technique that (a) is applied in a manner consistent with the fair value measurement objective and the other requirements of this Statement, (b) is based on established principles of financial economic theory[47] and generally applied in that field (paragraph A13), and (c) reflects all substantive characteristics of the instrument (except for those explicitly excluded by this Statement, such as vesting conditions and reload features). That is, the fair values of equity and liability instruments granted in a share-based payment transaction shall be estimated by applying a valuation technique that would be used in determining an amount at which instruments with the same characteristics (except for those explicitly excluded by this Statement) would be exchanged.

A9. An estimate of the amount at which instruments similar to employee share options and other instruments granted to employees would be exchanged would factor in expectations of the probability that the requisite service would be rendered and the instruments would vest (that is, that the performance or service conditions would be satisfied). However, as noted in paragraph A2, the measurement objective in this Statement is to estimate the fair value at the grant date of the equity instruments that the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments. Therefore, the estimated fair value of the instruments at grant date does not take into account the effect on fair value of vesting conditions and other restrictions that apply

[45]Determining whether an equity or liability instrument is similar is a matter of judgment, based on an analysis of the terms of the instrument and other relevant facts and circumstances.

[46]As of the issuance of this Statement, such market prices for equity share options and similar instruments granted to employees are generally not available; however, they may become so in the future.

[47]Established principles of financial economic theory represent fundamental propositions that form the basis of modern corporate finance (for example, the time value of money and risk-neutral valuation).

only during the requisite service period. Under the fair-value-based method required by this Statement, the effect of vesting conditions and other restrictions that apply only during the requisite service period is reflected by recognizing compensation cost only for instruments for which the requisite service is rendered.

Valuation Techniques

A10. In applying a valuation technique, the assumptions used should be consistent with the fair value measurement objective. That is, assumptions should reflect information that is (or would be) available to form the basis for an amount at which the instruments being valued would be exchanged. In estimating fair value, the assumptions used should not represent the biases of a particular party. Some of those assumptions will be based on or determined from external data. Other assumptions, such as the employees' expected exercise behavior, may be derived from the entity's own historical experience with share-based payment arrangements.

A11. The fair value of any equity or liability instrument depends on its substantive characteristics. Paragraph A18 lists the minimum set of substantive characteristics of instruments with option (or option-like) features that shall be considered in estimating those instruments' fair value. However, a share-based payment award could contain other characteristics, such as a market condition, that should be included in a fair value estimate. Judgment is required to identify an award's substantive characteristics and, as described in paragraphs A12–A17, to select a valuation technique that incorporates those characteristics.

A12. Valuation techniques used for employee share options and similar instruments estimate the fair value of those instruments at a single point in time (for example, at the grant date). The assumptions used in a fair value measurement are based on expectations at the time the measurement is made, and those expectations reflect the information that is available at the time of measurement. The fair value of those instruments will change over time as factors used in estimating their fair value subsequently change, for instance, as share prices fluctuate, risk-free interest rates change, or dividend streams are modified. Changes in the fair value of those instruments are a normal economic process to which any valuable resource is subject and do not indicate that the expectations on which previous fair value measurements were based were incorrect. The fair value of those instruments at a single point in time is not a forecast of what the estimated fair value of those instruments may be in the future.

Valuation Techniques for Share Options and Similar Instruments

A13. A **lattice model** (for example, a binomial model) and a **closed-form model** (for example, the Black-Scholes-Merton formula) are among the valuation techniques that meet the criteria required by this Statement for estimating the fair values of employee share options and similar instruments.[48] Those valuation techniques or models, sometimes referred to as *option-pricing models,* are based on established principles of financial economic theory. Those techniques are used by valuation professionals, dealers of derivative instruments, and others to estimate the fair values of options and similar instruments related to equity securities, currencies, interest rates, and commodities. Those techniques are used to establish trade prices for derivative instruments and to establish values in adjudications. As discussed in paragraphs A18–A42, both lattice models and closed-form models can be adjusted to account for the substantive characteristics of share options and similar instruments granted to employees.

A14. This Statement does not specify a preference for a particular valuation technique or model in estimating the fair values of employee share options and similar instruments. Rather, this Statement requires the use of a valuation technique or model that meets the measurement objective in paragraph 16 and the requirements in paragraph A8. The selection of an appropriate valuation technique or model will depend on the substantive characteristics of the instrument being valued.[49] For instance, the appropriate valuation technique or model selected to estimate the fair value of an instrument with a market condition must take into account the effect of that market condition. The designs of some techniques and models better reflect the substantive characteristics of a particular employee share option or similar instrument. Paragraphs A15–A17 discuss certain factors that an entity should consider in selecting a valuation technique or model for its employee share options or similar instruments.

A15. The Black-Scholes-Merton formula assumes that option exercises occur at the end of an option's contractual term, and that expected volatility, expected dividends, and risk-free interest rates are constant over the option's term. If used to estimate the fair value of instruments in the scope of this Statement, the Black-Scholes-Merton formula must be adjusted to take account of certain characteristics of employee share options and similar instruments that are not consistent with the model's assumptions (for example, the ability to exercise before the end of the option's contractual term).

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[48]A Monte Carlo simulation technique is another type of valuation technique that satisfies the requirements in paragraph A8. Other valuation techniques not mentioned in this Statement also may satisfy the requirements in paragraph A8.

[49]Because an entity may grant different types of instruments, each with its own unique set of substantive characteristics, an entity may use a different valuation technique for each different type of instrument.

Because of the nature of the formula, those adjustments take the form of weighted-average assumptions about those characteristics. In contrast, a lattice model can be designed to accommodate dynamic assumptions of expected volatility and dividends over the option's contractual term, and estimates of expected option exercise patterns during the option's contractual term, including the effect of **blackout periods.** Therefore, the design of a lattice model more fully reflects the substantive characteristics of a particular employee share option or similar instrument. Nevertheless, both a lattice model and the Black-Scholes-Merton formula, as well as other valuation techniques that meet the requirements in paragraph A8, can provide a fair value estimate that is consistent with the measurement objective and fair-value-based method of this Statement.

A16. Regardless of the valuation technique or model selected, an entity shall develop reasonable and supportable[50] estimates for each assumption used in the model, including the employee share option or similar instrument's expected term, taking into account both the contractual term of the option and the effects of employees' expected exercise and post-vesting employment termination behavior.

A17. An entity should change the valuation technique it uses to estimate fair value if it concludes that a different technique is likely to result in a better estimate of fair value (paragraph A23). For example, an entity that uses a closed-form model might conclude, when information becomes available, that a lattice model or another valuation technique would provide a fair value estimate that better achieves the fair value measurement objective and, therefore, change the valuation technique it uses.

SELECTING ASSUMPTIONS FOR USE IN AN OPTION-PRICING MODEL

A18. If an observable market price is not available for a share option or similar instrument with the same or similar terms and conditions, an entity shall estimate the fair value of that instrument using a valuation technique or model that meets the requirements in paragraph A8 and takes into account, at a minimum:

a. The exercise price of the option.
b. The expected term of the option, taking into account both the contractual term of the option and the effects of employees' expected exercise and post-vesting employment

[50]The term *supportable* is used in its general sense: "capable of being maintained, confirmed, or made good; defensible" (*The Compact Oxford English Dictionary,* 2nd edition, 1998). An application is supportable if it is based on reasonable arguments that consider the substantive characteristics of the instruments being valued and other relevant facts and circumstances.

termination behavior. In a closed-form model, the expected term is an assumption used in (or input to) the model, while in a lattice model, the expected term is an output of the model (refer to paragraphs A26–A30, which provide further explanation of the expected term in the context of a lattice model).

c. The current price of the underlying share.
d. The expected volatility of the price of the underlying share for the expected term of the option.
e. The expected dividends on the underlying share for the expected term of the option (except as provided in paragraphs A36 and A37).
f. The risk-free interest rate(s) for the expected term of the option.[51,52]

A19. Paragraphs A20–A24 provide general guidance on estimating assumptions used in a valuation technique or model. Expanded guidance for specific assumptions, such as expected term, expected volatility, and expected dividends, is provided in paragraphs A25–A42.

A20. There is likely to be a range of reasonable estimates for expected volatility, dividends, and term of the option. If no amount within the range is more or less likely than any other amount, an average of the amounts in the range (the *expected value*) should be used. In a lattice model, the assumptions used are to be determined for a particular node (or multiple nodes during a particular time period) of the lattice and not over multiple periods, unless such application is supportable.

A21. Historical experience is generally the starting point for developing expectations about the future. Expectations based on historical experience should be modified to reflect ways in which currently available information indicates that the future is reasonably expected to differ from the past. The appropriate weight to place on historical experience is a matter of judgment, based on relevant facts and circumstances. For example, an entity with two distinctly different lines of business of approximately equal size may dispose of the one that was significantly less volatile and generated more cash than the other. In that situation, the entity might place relatively

[51]The term *expected* in items (b), (d), (e), and (f) relates to expectations at the measurement date about the future evolution of the factor that is used as an assumption in a valuation model. The term is not necessarily used in the same sense as in the term *expected future cash flows* that appears elsewhere in FASB pronouncements.

[52]Items (d), (e), and (f) include the phrase *for the expected term of the option*. That phrase applies to both closed-form models and lattice models (as well as all other valuation techniques); however, if an entity uses a lattice model (or other similar valuation technique, for instance, a Monte Carlo simulation technique) that has been modified to take into account an option's contractual term and employees' expected exercise and post-vesting employment termination behavior, then items (d), (e), and (f) apply to the contractual term of the option.

little weight on volatility, dividends, and perhaps employees' exercise and post-vesting employment termination behavior from the predisposition (or disposition) period in developing reasonable expectations about the future. In contrast, an entity that has not undergone such a restructuring might place heavier weight on historical experience. That entity might conclude, based on its analysis of information available at the time of measurement, that its historical experience provides a reasonable estimate of expected volatility, dividends, and employees' exercise and post-vesting employment termination behavior.[53]

A22. In certain circumstances, historical information may not be available. For example, an entity whose common stock has only recently become publicly traded may have little, if any, historical information on the volatility of its own shares. That entity might base expectations about future volatility on the average volatilities of similar entities for an appropriate period following their going public. A nonpublic entity will need to exercise judgment in selecting a method to estimate expected volatility and might do so by basing its expected volatility on the average volatilities of otherwise similar public entities. For purposes of identifying otherwise similar entities, an entity would likely consider characteristics such as industry, stage of life cycle, size, and financial leverage. Because of the effects of diversification that are present in an industry sector index, the volatility of an index should not be substituted for the average of volatilities of otherwise similar entities in a fair value measurement.

Consistent Use of Valuation Techniques and Methods for Selecting Assumptions

A23. Assumptions used to estimate the fair value of equity and liability instruments granted to employees should be determined in a consistent manner from period to period. For example, an entity might use the closing share price or the share price at another specified time as the "current" share price on the grant date in estimating fair value, but whichever method is selected, it should be used consistently. The valuation technique an entity selects to estimate fair value for a particular type of instrument also should be used consistently and should not be changed unless a different valuation technique is expected to produce a better estimate of fair value. A change in either the valuation technique or the method of determining appropriate assumptions used in a

[53]This paragraph is not intended to suggest either that historical volatility is the only indicator of expected volatility or that an entity must identify a specific event in order to place less weight on historical experience. Expected volatility is an expectation of volatility over the expected term of an employee share option or similar instrument; that expectation should consider all relevant factors in paragraph A32, including possible mean reversion. Paragraphs A31–A34 provide further guidance on estimating expected volatility.

valuation technique is a change in accounting estimate for purposes of applying APB Opinion No. 20, *Accounting Changes,* and should be applied prospectively to new awards.

A24. Not all of the general guidance provided in paragraphs A2–A23 is repeated in the following discussion of factors to be considered in selecting specific assumptions. However, the general guidance is intended to apply to each individual assumption.

Risk-Free Interest Rate(s) for the Expected Term of the Option

A25. Option-pricing models call for the risk-free interest rate as an assumption to take into account, among other things, the time value of money. A U.S. entity issuing an option on its own shares must use as the risk-free interest rates the implied yields currently available from the U.S. Treasury zero-coupon yield curve over the contractual term of the option if the entity is using a lattice model incorporating the option's contractual term. If the entity is using a closed-form model, the risk-free interest rate is the implied yield currently available on U.S. Treasury zero-coupon issues with a remaining term equal to the expected term used as the assumption in the model. For entities based in jurisdictions outside the United States, the risk-free interest rate is the implied yield currently available on zero-coupon government issues denominated in the currency of the market in which the share (or underlying share), which is the basis for the instrument awarded, primarily trades. It may be necessary to use an appropriate substitute if no such government issues exist or if circumstances indicate that the implied yield on zero-coupon government issues is not representative of a risk-free interest rate.

Expected Term of Employee Share Options and Similar Instruments

A26. The fair value of a traded (or transferable) share option is based on its contractual term because rarely is it economically advantageous to exercise, rather than sell, a transferable share option before the end of its contractual term. Employee share options generally differ from transferable share options in that employees cannot sell (or hedge) their share options—they can only exercise them; because of this, employees generally exercise their options before the end of the options' contractual term. Thus, the inability to sell or hedge an employee share option effectively reduces the option's value because exercise prior to the option's expiration terminates its remaining life and thus its remaining time value. In addition, some employee share options contain prohibitions on exercise during blackout periods. To reflect the effect of those restrictions (which may lead to exercise prior to the end of the option's contractual term) on employee options relative to transferable options, this Statement requires that the fair value of an

employee share option or similar instrument be based on its expected term, rather than its contractual term (paragraphs A3 and A18).

A27. The expected term of an employee share option or similar instrument is the period of time for which the instrument is expected to be outstanding (that is, the period of time from the service inception date to the date of expected exercise or other expected settlement). The expected term is an assumption in a closed-form model. However, if an entity uses a lattice model that has been modified to take into account an option's contractual term and employees' expected exercise and post-vesting employment termination behavior, the expected term is estimated based on the resulting output of the lattice. For example, an entity's experience might indicate that option holders tend to exercise their options when the share price reaches 200 percent of the exercise price. If so, that entity might use a lattice model that assumes exercise of the option at each node along each share price path in a lattice at which the early exercise expectation is met, provided that the option is vested and exercisable at that point. Moreover, such a model would assume exercise at the end of the contractual term on price paths along which the exercise expectation is not met but the options are in-the-money[54] at the end of the contractual term. That method recognizes that employees' exercise behavior is correlated with the price of the underlying share. Employees' expected post-vesting employment termination behavior also would be factored in. Expected term, which is a required disclosure (paragraph A240), then could be estimated based on the output of the resulting lattice.[55]

A28. Other factors that may affect expectations about employees' exercise and post-vesting employment termination behavior include the following:

a. The vesting period of the award. An option's expected term must at least include the vesting period.[56]

[54]The terms *at-the-money, in-the-money,* and *out-of-the-money* are used to describe share options whose exercise price is equal to, less than, or greater than the market price of the underlying share, respectively.

[55]An example of an acceptable method for purposes of financial statement disclosures of estimating the expected term based on the results of a lattice model is to use the lattice model's estimated fair value of a share option as an input to a closed-form model, and then to solve the closed-form model for the expected term. Other methods also are available to estimate expected term.

[56]Under some share option arrangements, an option holder may exercise an option prior to vesting (usually to obtain a specific tax treatment); however, such arrangements generally require that any shares received upon exercise be returned to the entity (with or without a return of the exercise price to the holder) if the vesting conditions are not satisfied. Such an exercise is not substantive for accounting purposes.

b. Employees' historical exercise and post-vesting employment termination behavior for similar grants.
c. Expected volatility of the price of the underlying share.[57]
d. Blackout periods and other coexisting arrangements such as agreements that allow for exercise to automatically occur during blackout periods if certain conditions are satisfied.
e. Employees' ages, lengths of service, and home jurisdictions (that is, domestic or foreign).

A29. If sufficient information about employees' expected exercise and post-vesting employment termination behavior is available, a method like the one described in paragraph A27 might be used because that method reflects more information about the instrument being valued (paragraph A15). However, expected term might be estimated in some other manner, taking into account whatever relevant and supportable information is available, including industry averages and other pertinent evidence such as published academic research.

A30. Option value increases at a decreasing rate as the term lengthens (for most, if not all, options). For example, a two-year option is worth less than twice as much as a one-year option, other things equal. Accordingly, estimating the fair value of an option based on a single expected term that effectively averages the differing exercise and post-vesting employment termination behaviors of identifiable groups of employees will potentially misstate the value of the entire award. Aggregating individual awards into relatively homogenous groups with respect to exercise and post-vesting employment termination behaviors and estimating the fair value of the options granted to each group separately reduces such potential misstatement. An entity shall aggregate individual awards into relatively homogenous groups with respect to exercise and post-vesting employment termination behaviors regardless of the valuation technique or model used to estimate the fair value. For example, the historical experience of an employer that grants options broadly to all levels of employees might indicate that hourly employees tend to exercise for a smaller percentage gain than do salaried employees.

Expected Volatility

A31. Volatility is a measure of the amount by which a financial variable, such as share price, has fluctuated (historical volatility) or is expected to fluctuate (expected

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[57] An entity also might consider whether the evolution of the share price affects an employee's exercise behavior (for example, an employee may be more likely to exercise a share option shortly after it becomes in-the-money if the option had been out-of-the-money for a long period of time).

volatility) during a period. Volatility is defined more fully in Appendix E. Option-pricing models require expected volatility as an assumption because an option's value is dependent on potential share returns over the option's term. The higher the volatility, the more the returns on the shares can be expected to vary—up or down. Because an option's value is unaffected by expected negative returns on the shares, other things equal, an option on a share with higher volatility is worth more than an option on a share with lower volatility. This Statement does not specify a method of estimating expected volatility; rather, paragraph A32 provides a list of factors that should be considered in estimating expected volatility. An entity's estimate of expected volatility should be reasonable and supportable.

A32. Factors to consider in estimating expected volatility include:

a. Volatility of the share price, including changes in that volatility and possible mean reversion[58] of that volatility, over the most recent period that is generally commensurate with (1) the contractual term of the option if a lattice model is being used to estimate fair value or (2) the expected term of the option if a closed-form model is being used.[59] For example, in computing historical volatility, an entity might disregard an identifiable period of time in which its share price was extraordinarily volatile because of a failed takeover bid if a similar event is not expected to recur during the expected or contractual term. If an entity's share price was extremely volatile for an identifiable period of time, for instance, due to a general market decline, that entity might place less weight on its volatility during that period of time because of possible mean reversion.
b. The implied volatility of the share price determined from the market prices of traded options or other traded financial instruments such as outstanding convertible debt, if any.
c. For public companies, the length of time an entity's shares have been publicly traded. If that period is shorter than the expected or contractual term of the option, the term structure of volatility for the longest period for which trading activity is available should be more relevant. A newly public entity also might consider the

[58]Mean reversion refers to the tendency of a financial variable, such as volatility, to revert to some long-run average level. Statistical models have been developed that take into account the mean-reverting tendency of volatility.

[59]An entity might evaluate changes in volatility and mean reversion over that period by dividing the contractual or expected term into regular intervals and evaluating evolution of volatility through those intervals.

expected volatility of similar entities.[60] A nonpublic entity might base its expected volatility on the expected volatilities of entities that are similar except for having publicly traded securities.

d. Appropriate and regular intervals for price observations. If an entity considers historical volatility in estimating expected volatility, it should use intervals that are appropriate based on the facts and circumstances and that provide the basis for a reasonable fair value estimate. For example, a publicly traded entity would likely use daily price observations, while a nonpublic entity with shares that occasionally change hands at negotiated prices might use monthly price observations.
e. Corporate and capital structure. An entity's corporate structure may affect expected volatility (paragraph A21). An entity's capital structure also may affect expected volatility; for example, highly leveraged entities tend to have higher volatilities.

A33. A closed-form model, such as the Black-Scholes-Merton formula, cannot incorporate a range of expected volatilities over the option's expected term (paragraph A15). Lattice models can incorporate a term structure of expected volatility; that is, a range of expected volatilities can be incorporated into the lattice over an option's contractual term. Determining how to incorporate a range of expected volatilities into a lattice model to provide a reasonable fair value estimate is a matter of judgment and should be based on a careful consideration of the factors listed in paragraph A32 as well as other relevant factors that are consistent with the fair value measurement objective of this Statement.

A34. An entity should establish a process for estimating expected volatility and apply that process consistently from period to period (paragraph A23). That process (a) should comprehend an identification of information available to the entity and applicable factors such as those described in paragraph A32 and (b) should include a procedure for evaluating and weighting that information. The process developed by an entity will be determined by the information available to it and its assessment of how that information would be used to estimate fair value. For example, consistent with paragraph A21, an entity's starting point in estimating expected volatility might be its historical volatility. That entity also would consider the extent to which currently available information indicates that future volatility will differ from the historical volatility. An example of such information is implied volatility (from traded options or other instruments).

[60]In evaluating similarity, an entity would likely consider factors such as industry, stage of life cycle, size, and financial leverage.

Expected Dividends

A35. Option-pricing models generally call for expected dividend yield as an assumption. However, the models may be modified to use an expected dividend amount rather than a yield. An entity may use either its expected yield or its expected payments. Additionally, an entity's historical pattern of dividend increases (or decreases) should be considered. For example, if an entity has historically increased dividends by approximately 3 percent per year, its estimated share option value should not be based on a fixed dividend amount throughout the share option's expected term. As with other assumptions in an option-pricing model, an entity should use the expected dividends that would likely be reflected in an amount at which the option would be exchanged (paragraph A10).

Dividend-Protected Awards

A36. Expected dividends are taken into account in using an option-pricing model to estimate the fair value of a share option because dividends paid on the underlying shares reduce the fair value of those shares and option holders generally are not entitled to receive those dividends. However, an award of share options may be structured to protect option holders from that effect by providing them with some form of dividend rights. Such *dividend protection* may take a variety of forms and shall be appropriately reflected in estimating the fair value of a share option. For example, if a dividend paid on the underlying shares is applied to reduce the exercise price of the option, the effect of the dividend protection is appropriately reflected by using an expected dividend assumption of zero.

A37. In certain situations, employees may receive the dividends paid on the underlying equity shares while the option is outstanding. Dividends or dividend equivalents paid to employees on the portion of an award of equity shares or other equity instruments that vests shall be charged to retained earnings. If employees are not required to return the dividends or dividend equivalents received if they forfeit their awards, dividends or dividend equivalents paid on instruments that do not vest shall be recognized as additional compensation cost.[61]

[61]The estimate of compensation cost for dividends or dividend equivalents paid on instruments that are not expected to vest shall be consistent with an entity's estimates of forfeitures (paragraphs 43–45).

Other Considerations

Dilution

A38. Traded options ordinarily are written by parties other than the entity that issues the underlying shares, and when exercised result in an exchange of already outstanding shares between those parties. In contrast, exercise of employee share options results in the issuance of new shares by the entity that wrote the option (the employer), which increases the number of shares outstanding. That dilution might reduce the fair value of the underlying shares, which in turn might reduce the benefit realized from option exercise.

A39. If the market for an entity's shares is reasonably efficient, the effect of potential dilution from the exercise of employee share options will be reflected in the market price of the underlying shares, and no adjustment for potential dilution usually is needed in estimating the fair value of the employee share options. For a public entity, an exception might be a large grant of options that the market is not expecting, and also does not believe will result in commensurate benefit to the entity. For a nonpublic entity, on the other hand, potential dilution may not be fully reflected in the share price if sufficient information about the frequency and size of the entity's grants of equity share options is not available for third parties who may exchange the entity's shares to anticipate the dilutive effect.

A40. An entity should consider whether the potential dilutive effect of an award of share options needs to be reflected in estimating the fair value of its options at the grant date. For public entities, the Board expects that situations in which such a separate adjustment is needed will be rare.

Credit Risk

A41. An entity may need to consider the effect of its credit risk on the estimated fair value of liability awards that contain cash settlement features because potential cash payoffs from the awards are not independent of the entity's risk of default. Any credit-risk adjustment to the estimated fair value of awards with cash payoffs that increase with increases in the price of the underlying share is expected to be de minimis because increases in an entity's share price generally are positively associated with its ability to liquidate its liabilities. However, a credit-risk adjustment to the estimated fair value of awards with cash payoffs that increase with decreases in the price of the entity's shares may be necessary because decreases in an entity's share price generally are negatively associated with an entity's ability to liquidate its liabilities.

Certain Contingent Features

A42. Contingent features that might cause an employee to return to the entity either equity shares earned or realized gains from the sale of equity instruments earned as a result of share-based payment arrangements, such as a clawback feature (refer to paragraph A5, footnote 44), shall not be reflected in estimating the grant-date fair value of an equity instrument. Instead, the effect of such a contingent feature shall be accounted for if and when the contingent event occurs. For instance, a share-based payment arrangement may stipulate the return of vested equity shares to the issuing entity for no consideration if the employee terminates the employment relationship to work for a competitor. The effect of that provision on the grant-date fair value of the equity shares shall not be considered. If the issuing entity subsequently receives those shares (or their equivalent value in cash or other assets) as a result of that provision, a credit shall be recognized in the income statement upon the receipt of the shares. That credit is limited to the lesser of the recognized compensation cost associated with the share-based payment arrangement that contains the contingent feature and the fair value of the consideration received.[62] Illustration 15 (paragraphs A190 and A191) provides an example of the accounting for an award that contains a clawback feature.

CALCULATED VALUE METHOD FOR CERTAIN NONPUBLIC ENTITIES

A43. Nonpublic entities may have sufficient information available on which to base a reasonable and supportable estimate of the expected volatility of their share prices. For example, a nonpublic entity that has an internal market for its shares, has private transactions in its shares, or issues new equity or convertible debt instruments may be able to consider the historical volatility, or implied volatility, of its share price in estimating expected volatility. Alternatively, a nonpublic entity that can identify similar public entities[63] for which share or option price information is available may be able to consider the historical, expected, or implied volatility of those entities' share prices in estimating expected volatility.

A44. This Statement requires all entities to use the fair-value-based method to account for share-based payment arrangements that are classified as equity instruments.

[62]The event is recognized in the income statement because the resulting transaction takes place with an employee (or former employee) as a result of the current (or prior) employment relationship rather than as a result of the employee's role as an equity owner.

[63]A nonpublic entity may have identified similar public entities that it uses to estimate the fair value of its shares or to benchmark various aspects of its performance (paragraph A22).

However, if it is not practicable for a nonpublic entity to estimate the expected volatility of its share price, paragraph 23 of this Statement requires it to use the calculated value method.[64]

A45. For purposes of this Statement, it is not practicable for a nonpublic entity to estimate the expected volatility of its share price if it is unable to obtain sufficient historical information about past volatility, or other information such as that noted in paragraph A43, on which to base a reasonable and supportable estimate of expected volatility at the grant date of the award without undue cost and effort. In that situation, this Statement requires a nonpublic entity to estimate a value for its equity share options and similar instruments by substituting the historical volatility of an appropriate industry sector index for the expected volatility of its share price as an assumption in its valuation model. All other inputs to a nonpublic entity's valuation model should be determined in accordance with the guidance in paragraphs A2–A42.

A46. There are many different indices available to consider in selecting an appropriate industry sector index.[65] An appropriate industry sector index is one that is representative of the industry sector in which the nonpublic entity operates and that also reflects, if possible, the size of the entity. If a nonpublic entity operates in a variety of different industry sectors, then it might select a number of different industry sector indices and weight them according to the nature of its operations; alternatively, it might select an index for the industry sector that is most representative of its operations. If a nonpublic entity operates in an industry sector in which no public entities operate, then it should select an index for the industry sector that is most closely related to the nature of its operations. However, in no circumstances shall a nonpublic entity use a broad-based market index like the S&P 500, Russell 3000®, or Dow Jones Wilshire 5000 because those indices are sufficiently diversified as to be not representative of the industry sector, or sectors, in which the nonpublic entity operates.

A47. A nonpublic entity shall use the selected index consistently in applying the calculated value method (a) for all of its equity share options or similar instruments and

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[64]It may not be possible for a nonpublic entity to reasonably estimate the fair value of its equity share options and similar instruments at the date they are granted because the complexity of the award's terms prevents it from doing so. In that case, paragraphs 24 and 25 of this Statement require that the nonpublic entity account for its equity instruments at their intrinsic value, remeasured at each reporting date through the date of exercise or other settlement.

[65]For example, Dow Jones Indexes maintain a global series of stock market indices with industry sector splits available for many countries, including the United States. The historical values of those indices are easily obtainable from its website.

(b) in each accounting period, unless the nature of the entity's operations changes such that another industry sector index is more appropriate.

A48. The calculation of the historical volatility of an appropriate industry sector index should be made using the daily historical closing values[66] of the index selected for the period of time prior to the grant date (or service inception date) of the equity share option or similar instrument that is equal in length to the expected term of the equity share option or similar instrument. If historical closing values of the index selected are not available for the entire expected term, then a nonpublic entity shall use the closing values for the longest period of time available. The method used shall be consistently applied (paragraph A23). Illustration 11(b) (paragraphs A137–A142) provides an example of accounting for an equity share option award granted by a nonpublic entity that uses the calculated value method.

ILLUSTRATIVE COMPUTATIONS AND OTHER GUIDANCE

Market, Performance, and Service Conditions

Market, Performance, and Service Conditions That Affect Vesting and Exercisability

A49. An employee's share-based payment award becomes vested at the date that the employee's right to receive or retain equity shares, other equity instruments, or assets under the award is no longer contingent on satisfaction of either a performance condition or a service condition. This Statement distinguishes among market conditions, performance conditions, and service conditions that affect the vesting or exercisability of an award[67] (paragraph 19). Other conditions affecting vesting, exercisability, exercise price, and other pertinent factors in measuring fair value that do not meet the definitions of a market condition, performance condition, or service condition are discussed in paragraph A53.

A50. Analysis of the market, performance, or service conditions (or any combination thereof) that are explicit or implicit in the terms of an award is required to determine the requisite service period over which compensation cost is recognized and whether

[66]If daily values are not readily available, then an entity shall use the most frequent observations available of the historical closing values of the selected index.

[67]Exercisability is used for market conditions in the same context as vesting is used for performance and service conditions.

recognized compensation cost may be reversed if an award fails to vest or become exercisable (paragraphs 47 and 48). If exercisability or the ability to retain the award, for example, an award of equity shares may contain a market condition that affects the employee's ability to retain those shares is based solely on one or more market conditions, compensation cost for that award is recognized if the employee renders the requisite service, even if the market condition is not satisfied.[68] If exercisability (or the ability to retain the award) is based solely on one or more market conditions, compensation cost for that award is reversed if the employee does not render the requisite service, unless the market condition is satisfied prior to the end of the requisite service period, in which case any unrecognized compensation cost would be recognized at the time the market condition is satisfied. If vesting is based solely on one or more performance or service conditions, any previously recognized compensation cost is reversed if the award does not vest (that is, the requisite service is not rendered). Illustrations 4 and 5 (paragraphs A86–A110) are examples of awards in which vesting is based solely on performance or service conditions.

A51. Vesting or exercisability may be conditional on satisfying two or more types of conditions (for example, vesting and exercisability occur upon satisfying both a market *and* a performance or service condition). Vesting also may be conditional on satisfying one of two or more types of conditions (for example, vesting and exercisability occur upon satisfying either a market condition *or* a performance or service condition). Regardless of the nature and number of conditions that must be satisfied, the existence of a market condition requires recognition of compensation cost if the requisite service is rendered, even if the market condition is never satisfied. Even if only one of two or more conditions must be satisfied and a market condition is present in the terms of the award, then compensation cost is recognized if the requisite service is rendered, regardless of whether the market, performance, or service condition is satisfied (paragraphs A72–A74 provide an example of such an award).

Market, Performance, and Service Conditions That Affect Factors Other Than Vesting and Exercisability

A52. Market, performance, and service conditions may affect an award's exercise price, contractual term, quantity, conversion ratio, or other pertinent factors that are relevant in measuring an award's fair value. For instance, an award's quantity may double, or an award's contractual term may be extended, if a company-wide revenue target is achieved. Market conditions that affect an award's fair value (including

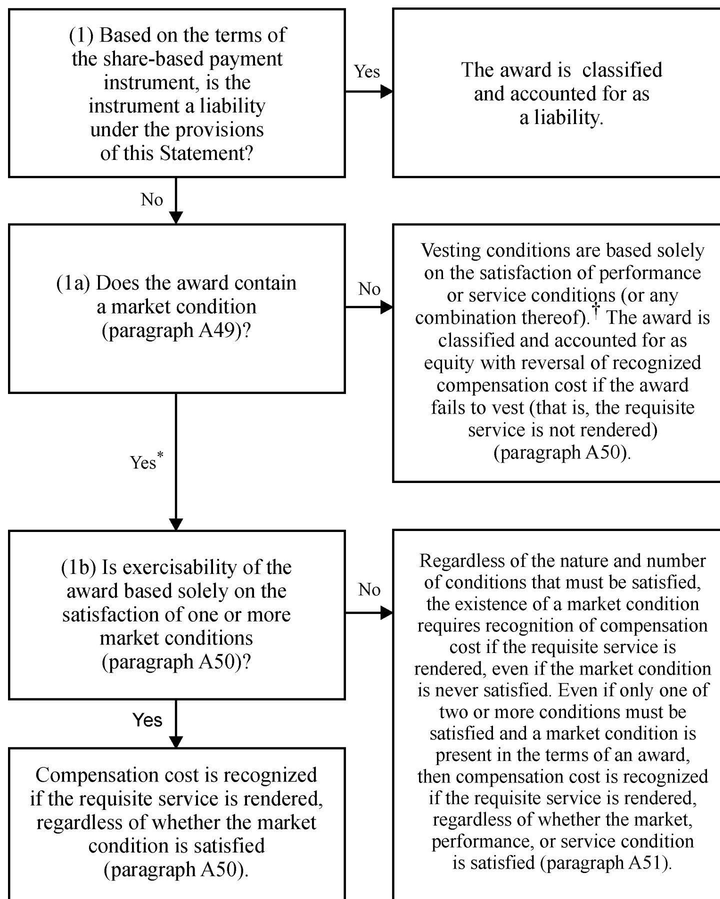
[68]An award containing one or more market conditions may have an explicit, implicit, or derived service period (refer to Appendix E). Paragraphs A59–A74 provide guidance on explicit, implicit, and derived service periods.

exercisability) are included in the estimate of grant-date fair value (paragraph 49). Performance or service conditions that only affect vesting are excluded from the estimate of grant-date fair value, but all other performance or service conditions that affect an award's fair value are included in the estimate of grant-date fair value (paragraph 49). Illustrations 5(b) (paragraphs A109 and A110), 6 (paragraphs A111–A113), and 8 (paragraphs A121–A124) provide further guidance on how performance conditions are considered in the estimate of grant-date fair value.

A53. An award may be indexed to a factor in addition to the entity's share price. If that factor is not a market, performance, or service condition, that award shall be classified as a liability for purposes of this Statement (paragraph 33). An example would be an award of options whose exercise price is indexed to the market price of a commodity, such as gold. Another example would be a share award that will vest based on the appreciation in the price of a commodity such as gold; that award is indexed to both the value of that commodity and the issuing entity's shares. If an award is so indexed, the relevant factors should be included in the fair value estimate of the award. Such an award would be classified as a liability even if the entity granting the share-based payment instrument is a producer of the commodity whose price changes are part or all of the conditions that affect an award's vesting conditions or fair value.

A54. The following flowchart provides guidance on determining how to account for an award based on the existence of market, performance, or service conditions (or any combination thereof).

Accounting for Awards with Market, Performance, or Service Conditions



*The award should be classified and accounted for as equity. Market conditions are included in the grant-date fair value estimate of the award.

†Performance and service conditions that affect vesting are not included in estimating the grant-date fair value of the award. Performance and service conditions that affect the exercise price, contractual term, conversion ratio, or other pertinent factors affecting the fair value of an award are included in estimating the grant-date fair value of the award.

Estimating the Requisite Service Period of Awards with Market, Performance, and Service Conditions

A55. Paragraph 39 of this Statement requires that compensation cost be recognized over the requisite service period. The requisite service period for an award that has only a service condition is presumed to be the vesting period, unless there is clear evidence to the contrary. The requisite service period should be estimated based on an analysis of the terms of the award and other relevant facts and circumstances, including co-existing employment agreements and an entity's past practices; that estimate should ignore nonsubstantive vesting conditions. For example, the grant of a deep out-of-the-money share option award without an explicit service condition will have a derived service period.[69] If a market, performance, or service condition requires future service for vesting (or exercisability), an entity cannot define a prior period as the requisite service period. The requisite service period for awards with market, performance, or service conditions (or any combination thereof) should be consistent with assumptions used in estimating the grant-date fair value of those awards.

A56. An employee's share-based payment award becomes vested at the date that the employee's right to receive or retain equity shares, other equity instruments, or cash under the award is no longer contingent on satisfaction of either a performance condition or a service condition. Any unrecognized compensation cost shall be recognized when an award becomes vested. If an award includes no market, performance, or service conditions, then the entire amount of compensation cost should be recognized when the award is granted (which also is the date of issuance in this case).

A57. For example, assume that Entity A uses a point system for retirement. An employee who accumulates 60 points becomes eligible to retire with certain benefits, including the retention of any nonvested share-based payment awards for their remaining contractual life, even if another explicit service condition has not been satisfied. In this case, the point system effectively accelerates vesting. On January 1, 20X5, an employee receives at-the-money options on 100 shares of Entity A's stock. All options vest at the end of 3 years of service and have a 10-year contractual term. At the grant date, the employee has 60 points and, therefore, is eligible to retire at any time.

[69]Likewise, if an award with an explicit service condition that was at-the-money when granted is subsequently modified to accelerate vesting at a time when the award is deep out-of-the-money, that modification is not substantive because the explicit service condition is replaced by a derived service condition.

A58. Because the employee is eligible to retire at the grant date, the award's explicit service condition is nonsubstantive. Consequently, Entity A has granted an award that does not contain a performance or service condition for vesting, that is, the award is effectively vested, and thus, the award's entire fair value should be recognized as compensation cost on the grant date. All of the terms of a share-based payment award and other relevant facts and circumstances must be analyzed when determining the requisite service period.

Explicit, Implicit, and Derived Requisite Service Periods

A59. A requisite service period may be explicit, implicit, or derived. An explicit service period is one that is stated in the terms of the share-based payment award. For example, an award that vests after three years of continuous employee service has an explicit service period of three years, which also would be the requisite service period. An implicit service period is one that may be inferred from an analysis of an award's terms. For example, if an award of share options vests only upon the completion of a new product design and the design is expected to be completed 18 months from the grant date, the implicit service period is 18 months, which also would be the requisite service period.

A60. A derived service period is based on a market condition in a share-based payment award that affects exercisability, exercise price, or the employee's ability to retain the award. A derived service period is inferred from the application of certain valuation techniques used to estimate fair value.[70] For example, the derived service period for an award of share options that an employee can exercise only if the share price doubles at any time during a five-year period can be inferred from certain valuation techniques that are used to estimate fair value.[71] In a lattice model, that derived service period represents the duration of the median of the distribution of share price paths on which the market condition is satisfied. That median is the middle share price path (the midpoint of the distribution of paths) on which the market condition is satisfied. The duration is the period of time from the service inception date to the expected date of market condition satisfaction (as inferred from the valuation technique). For example, if the derived service period is three years, the requisite service period is three years and all compensation cost would be recognized over that period, unless the market condition is satisfied at an earlier date, in which case any unrecognized compensation

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[70]An entity that uses a closed-form model to estimate the grant-date fair value of an award with a market condition may need to use another valuation technique to estimate the derived service period.

[71]This example, and others noted in Appendix A, implicitly assume that the rights conveyed by the instrument to the holder are dependent on the holder's being an employee of the entity. That is, if the employment relationship is terminated, the award lapses or is forfeited shortly thereafter.

cost would be recognized immediately upon its satisfaction. If the requisite service is not rendered, all previously recognized compensation cost would be reversed. If the requisite service is rendered, the recognized compensation is not reversed even if the market condition is never satisfied.

A61. An award with a combination of market, performance, or service conditions may contain multiple explicit, implicit, or derived service periods. For such an award, the estimate of the requisite service period shall be based on an analysis of (a) all vesting and exercisability conditions, (b) all explicit, implicit, and derived service periods, and (c) the probability that performance or service conditions will be satisfied. Thus, if vesting (or exercisability) of an award is based on satisfying both a market condition *and* a performance or service condition and it is probable that the performance or service condition will be satisfied, the initial estimate of the requisite service period generally is the longest of the explicit, implicit, or derived service periods. If vesting (or exercisability) of an award is based on satisfying either a market condition *or* a performance or service condition and it is probable that the performance or service condition will be satisfied, the initial estimate of the requisite service period generally is the shortest of the explicit, implicit, or derived service periods.

A62. For example, a share option might specify that vesting occurs after three years of continuous employee service *or* when the employee completes a specified project. The employer estimates that it is probable[72] that the project will be completed within 18 months. The employer also believes it is probable that the service condition will be satisfied. Thus, that award contains an explicit service period of 3 years related to the service condition and an implicit service period of 18 months related to the performance condition. Because it is considered probable that both the performance condition and the service condition will be achieved, the requisite service period over which compensation cost is recognized is 18 months, which is the shorter of the explicit and implicit service periods.

A63. As illustrated in paragraph A62, if an award vests upon the earlier of the satisfaction of a service condition (for example, four years of service) *or* the satisfaction of one or more performance conditions, it will be necessary to estimate when, if at all, the performance conditions are probable of achievement. For example, if initially the four-year service condition is probable of achievement and no performance condition is probable of achievement, the requisite service period is four years. If one year into the four-year requisite service period a performance condition becomes probable of

[72]*Probable* is used in the same sense as in FASB Statement No. 5, *Accounting for Contingencies:* "the future event or events are likely to occur" (paragraph 3).

achievement by the end of the second year, the requisite service period would be revised to two years for attribution of compensation cost (at that point in time, there would be only one year of the two-year requisite service period remaining).

A64. If an award vests upon the satisfaction of both a service condition *and* the satisfaction of one or more performance conditions, the entity also must initially determine which outcomes are probable of achievement. For example, an award contains a four-year service condition and two performance conditions, all of which need to be satisfied. If initially the four-year service condition is probable of achievement and no performance condition is probable of achievement, then no compensation cost would be recognized unless the two performance conditions and the service condition subsequently become probable of achievement. If both performance conditions become probable of achievement one year after the grant date and the entity estimates that both performance conditions will be achieved by the end of the second year, the requisite service period would be four years as that is the longest period of both the explicit service period and the implicit service periods. Because the requisite service is now expected to be rendered, compensation cost will be recognized in the period of the change in estimate (paragraph 43) as the cumulative effect on current and prior periods of the change in the estimated number of awards for which the requisite service is expected to be rendered. Therefore, compensation cost for the first year will be recognized immediately at the time of the change in estimate for the awards for which the requisite service is expected to be rendered. The remaining unrecognized compensation cost for those awards would be recognized prospectively over the remaining requisite service period.

A65. As indicated in paragraph A63, the initial estimate of the requisite service period based on an explicit or implicit service period shall be adjusted for changes in the expected and actual outcomes of the related service or performance conditions that affect vesting of the award. Such adjustments will occur as the entity revises its estimates of whether or when different conditions or combinations of conditions are probable of being satisfied. Compensation cost ultimately recognized is equal to the grant-date fair value of the award based on the actual outcome of the performance or service conditions (paragraph 49). If an award contains a market condition *and* a performance or a service condition and the initial estimate of the requisite service period is based on the market condition's derived service period, then the requisite service period shall not be revised unless (a) the market condition is satisfied before the end of the derived service period or (b) satisfying the market condition is no longer the basis for determining the requisite service period.

A66. How a change to the initial estimate of the requisite service period is accounted for depends on whether that change would affect the grant-date fair value of the award

(including the quantity of instruments) that is to be recognized as compensation. For example, if the quantity of instruments for which the requisite service is expected to be rendered changes because a vesting condition becomes probable of satisfaction or if the grant-date fair value of an instrument changes because another performance or service condition becomes probable of satisfaction (for example, a performance or service condition that affects exercise price becomes probable of satisfaction), the cumulative effect on current and prior periods of those changes in estimates shall be recognized in the period of the change. In contrast, if compensation cost is already being attributed over an initially estimated requisite service period and that initially estimated period changes solely because another market, performance, or service condition becomes the basis for the requisite service period, any unrecognized compensation cost at that date of change shall be recognized prospectively over the revised requisite service period, if any (that is, no cumulative-effect adjustment is recognized). To summarize, changes in actual or estimated outcomes that affect either the grant-date fair value of the instrument awarded or the quantity of instruments for which the requisite service is expected to be rendered (or both) are accounted for using a cumulative effect adjustment, and changes in estimated requisite service periods for awards for which compensation cost is already being attributed are accounted for prospectively only over the revised requisite service period, if any.

Share-Based Payment Award with a Performance Condition and Multiple Service Periods

A67. On January 1, 20X5, Entity T enters into an arrangement with its chief executive officer (CEO) relating to 40,000 share options on its stock with an exercise price of $30 per option. The arrangement is structured such that 10,000 share options will vest or be forfeited in each of the next 4 years (20X5 through 20X8) depending on whether annual performance targets relating to Entity T's revenues and net income are achieved. All of the annual performance targets are set at the inception of the arrangement. Because a mutual understanding of the key terms and conditions is reached on January 1, 20X5, each tranche would have a grant date and, therefore, a measurement date, of January 1, 20X5. However, each tranche of 10,000 share options should be accounted for as a separate award with its own service inception date, grant-date fair value, and 1-year requisite service period, because the arrangement specifies for each tranche an independent performance condition for a stated period of service. The CEO's ability to retain (vest in) the award pertaining to 20X5 is not dependent on service beyond 20X5, and the failure to satisfy the performance condition in any one particular year has no effect on the outcome of any preceding or subsequent period. This arrangement is similar to an arrangement that would have provided a $10,000 cash bonus for each year for satisfaction of the same performance conditions. The four separate service inception dates (one for each tranche) are at the beginning of each year.

A68. If the arrangement had instead provided that the annual performance targets would be established during January of each year, the grant date (and, therefore, the measurement date) for each tranche would be that date in January of each year (20X5 through 20X8) because a mutual understanding of the key terms and conditions would not be reached until then. In that case, each tranche of 10,000 share options has its own service inception date, grant-date fair value, and 1-year requisite service period. The fair value measurement of compensation cost for each tranche would be affected because not all of the key terms and conditions of each award are known until the compensation committee sets the performance targets and, therefore, the grant dates are those dates.

A69. If the arrangement in paragraph A67 instead stated that the vesting for awards in periods from 20X6 through 20X8 was dependent on satisfaction of the performance targets related to the preceding award, the requisite service provided in exchange for each preceding award would not be independent of the requisite service provided in exchange for each successive award. In contrast to the arrangement described in paragraph A67, failure to achieve the annual performance targets in 20X5 would result in forfeiture of all awards. The requisite service provided in exchange for each successive award is dependent on the requisite service provided for each preceding award. In that circumstance, all awards have the same service inception date and the same grant date (January 1, 20X5); however, each award has its own explicit service period (for example, the 20X5 grant has a one-year service period, the 20X6 grant has a two-year service period, and so on) over which compensation cost would be recognized.[73]

Share-Based Payment Award with a Service Condition and Multiple Service Periods

A70. The CEO of Entity T enters into a five-year employment contract on January 1, 20X5. The contract stipulates that the CEO will be given 10,000 fully vested share options at the end of each year (50,000 share options in total). The exercise price of each tranche will be equal to the market price at the date of issuance (December 31 of each year in the five-year contractual term). In this fact pattern, there are five separate grant dates. The grant date for each tranche is December 31 of each year because that is the date when there is a mutual understanding of the key terms and conditions of the agreement—that is, the exercise price is known and the CEO begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares (refer to paragraphs A77 and A78 for additional guidance on determining the grant date). Because the awards' terms do not include a substantive future requisite

[73]Because this award contains a performance condition, it is not subject to the attribution guidance in paragraph 42 of this Statement.

service condition that exists at the grant date (the options are fully vested when they are issued), and the exercise price (and, therefore, the grant date) is determined at the end of each period, the service inception date precedes the grant date. The requisite service provided in exchange for the first award (pertaining to 20X5) is independent of the requisite service provided in exchange for each consecutive award. The terms of the share-based compensation arrangement provide evidence that each tranche compensates the CEO for one year of service, and each tranche should be accounted for as a separate award with its own service inception date, grant date, and one-year service period; therefore, the provisions of paragraph 42 would not be applicable to this award because of its structure.

A71. If the arrangement described in paragraph A70 provided instead that the exercise price for all 50,000 share options would be the January 1, 20X5, market price, then the grant date (and, therefore, the measurement date) for each tranche would be January 1, 20X5, because that is the date at which there is a mutual understanding of the key terms and conditions. All tranches would have the same service inception date and the same grant date (January 1, 20X5). Because of the nature of this award, Entity T would make a policy decision pursuant to paragraph 42 of this Statement as to whether it considers the award as, in-substance, multiple awards each with its own requisite service period (that is, the 20X5 grant has a one-year service period, the 20X6 grant has a two-year service period, and so on) or whether the entity considers the award as a single award with a single requisite service period based on the last separately vesting portion of the award (that is, a requisite service period of five years). Once chosen, this Statement requires that accounting policy be applied consistently to all similar awards.

Share-Based Payment Award with Market and Service Conditions and Multiple Service Periods

A72. On January 1, 20X5, Entity T grants an executive 200,000 share options on its stock with an exercise price of $30 per option. The award specifies that vesting (or exercisability) will occur upon the earlier of (a) the share price reaching and maintaining at least $70 per share for 30 consecutive trading days *or* (b) the completion of 8 years of service. That award contains an explicit service period of eight years related to the service condition and a derived service period related to the market condition.

A73. An entity shall make its best estimate of the derived service period related to the market condition (refer to paragraph A60 and Appendix E).[74] For this example, the

[74]The derived service period may be estimated using any reasonable methodology, including Monte Carlo simulation techniques.

derived service period is assumed to be six years. As described in paragraph A61, if an award's vesting (or exercisability) is conditional upon the achievement of *either* a market condition *or* performance or service conditions, the requisite service period is generally the shortest of the explicit, implicit, and derived service periods. In this example, the requisite service period over which compensation cost should be attributed is six years (shorter of eight and six years).[75] Continuing with the example in paragraph A72, if the market condition is actually satisfied in February 20X9 (based on market prices for the prior 30 consecutive trading days) Entity T would immediately recognize any unrecognized compensation cost, because no further service is required to earn the award. If the market condition is not satisfied as of that date, but the executive renders the six years of requisite service, compensation cost shall not be reversed under any circumstances.

A74. The initial estimate of the requisite service period for an award requiring satisfaction of both market *and* performance or service conditions is generally the longest of the explicit, implicit, and derived service periods (paragraph A61). For example, if the award described in paragraph A72 required *both* the completion of 8 years of service *and* the share price reaching and maintaining at least $70 per share for 30 consecutive trading days, compensation cost would be recognized over the 8-year explicit service period. If the employee were to terminate service prior to the eight-year requisite service period, compensation cost would be reversed even if the market condition had been satisfied by that time.

Illustration 1—Definition of Employee

A75. This Statement defines employee as an individual over whom the grantor of a share-based compensation award exercises or has the right to exercise sufficient control to establish an employer-employee relationship based on common law as illustrated in case law and currently under U.S. Internal Revenue Service Revenue Ruling 87-41 (refer to Appendix E for a complete definition of the term *employee*). An example of whether that condition exists follows. Entity A issues options to members of its Advisory Board, which is separate and distinct from Entity A's board of directors. Members of the Advisory Board are knowledgeable about Entity A's industry and advise Entity A on matters such as policy development, strategic planning, and product development. The Advisory Board members are appointed for two-year terms and meet four times a year for one day, receiving a fixed number of options for services rendered

[75]An entity may grant a fully vested deep out-of-the-money share option that would lapse shortly after termination of service, which is the equivalent of an award with both a market condition and a service condition. The explicit service period associated with the explicit service condition is zero; however, because the option is deep out-of-the-money at the grant date, there would be a derived service period.

at each meeting. Based on an evaluation of the relationship between Entity A and the Advisory Board members, Entity A concludes that the Advisory Board members do not meet the common law definition of employee. Accordingly, the awards to the Advisory Board members are accounted for as awards to nonemployees under the provisions of this Statement.

A76. The definition of employee in Appendix E states that nonemployee directors acting in their role as members of an entity's board of directors shall be treated as employees if those directors were elected by the entity's shareholders or appointed to a board position that will be filled by shareholder election when the existing term expires. However, that requirement applies only to awards granted to them for their services as directors. Awards granted to those individuals for other services should be accounted for as awards to nonemployees in accordance with paragraphs 5–8 of this Statement. Additionally, consolidated groups may have multiple boards of directors; this guidance applies only to (a) the nonemployee directors acting in their role as members of a parent entity's board of directors and (b) nonemployee members of a consolidated subsidiary's board of directors to the extent that those members are elected by shareholders that are not controlled directly or indirectly by the parent or another member of the consolidated group.

Illustration 2—Determining the Grant Date

A77. The definition of *grant date* requires that an employer and employee have a mutual understanding of the key terms and conditions of the share-based compensation arrangement (Appendix E). Those terms may be established through a formal, written agreement; an informal, oral arrangement; or established by an entity's past practice. A mutual understanding of the key terms and conditions means that there is sufficient basis for both the employer and the employee to understand the nature of the relationship established by the award, including both the compensatory relationship and the equity relationship subsequent to the date of grant. The grant date for an award will be the date that an employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares. In order to assess that financial exposure, the employer and employee must agree to the terms; that is, there must be a mutual understanding. Awards made under an arrangement that is subject to shareholder approval are not deemed to be granted until that approval is obtained unless approval is essentially a formality (or perfunctory). Additionally, to have a grant date for an award to an employee, the recipient of that award must meet the definition of *employee* in Appendix E.

A78. The determination of the grant date shall be based on the relevant facts and circumstances. For instance, a look-back share option may be granted with an exercise

price equal to the lower of the current share price or the share price one year hence. The ultimate exercise price is not known at the date of grant, but it cannot be greater than the current share price. In this case, the relationship between the exercise price and the current share price provides a sufficient basis to understand both the compensatory and equity relationship established by the award; the recipient begins to benefit from subsequent changes in the price of the employer's equity shares. However, if the award's terms call for the exercise price to be set equal to the share price one year hence, the recipient does not begin to benefit from, or be adversely affected by, changes in the price of the employer's equity shares until then.[76] Therefore, grant date would not occur until one year hence.

Illustration 3—Service Inception Date and Grant Date

A79. This Statement distinguishes between service inception date and grant date (refer to Appendix E of this Statement for definitions of *service inception date* and *grant date*). The service inception date is the date at which the requisite service period begins. The service inception date usually is the grant date, but the service inception date precedes the grant date if (a) an award is authorized,[77] (b) service begins before a mutual understanding of the key terms and conditions of a share-based payment award is reached, *and* (c) either of the following conditions applies: (1) the award's terms do not include a substantive future requisite service condition that exists at the grant date (refer to paragraph A83 for an example illustrating that condition) or (2) the award contains a market or performance condition that if not satisfied during the service period preceding the grant date and following the inception of the arrangement results in forfeiture of the award (refer to paragraph A84 for an example illustrating that condition). In certain circumstances the service inception date may begin after the grant date (refer to paragraph A67 for an example illustrating that circumstance).

A80. For example, Entity T offers a position to an individual on April 1, 20X5, that has been approved by the CEO and board of directors. In addition to salary and other benefits, Entity T offers to grant 10,000 shares of Entity T stock that vest upon the completion of 5 years of service (the market price of Entity T's stock is $25 on April 1, 20X5). The share award will begin vesting on the date the offer is accepted. The individual accepts the offer on April 2, 20X5, but is unable to begin providing services to Entity T until June 2, 20X5 (that is, substantive employment begins on June 2,

[76]Awards of share options whose exercise price is determined solely by reference to a future share price generally would not provide a sufficient basis to understand the nature of the compensatory and equity relationships established by the award until the exercise price is known.

[77]Compensation cost would not be recognized prior to receiving all necessary approvals unless approval is essentially a formality (or perfunctory).

20X5). The individual also does not receive a salary or participate in other employee benefits until June 2, 20X5. On June 2, 20X5, the market price of Entity T stock is $40. In this example, the service inception date is June 2, 20X5, the first date that the individual begins providing substantive employee services to Entity T. The grant date is the same date because that is when the individual would meet the definition of an employee. The grant-date fair value of the share award is $400,000 (10,000 × $40).

A81. If necessary board approval of the award described in paragraph A80 was obtained on August 5, 20X5, two months after substantive employment begins (June 2, 20X5), both the service inception date *and* the grant date would be August 5, 20X5, as that is the date when all necessary authorizations were obtained. If the market price of Entity T's stock was $38 per share on August 5, 20X5, the grant-date fair value of the share award would be $380,000 (10,000 × $38). Additionally, Entity T would not recognize compensation cost for the shares for the period between June 2, 20X5, and August 4, 20X5, neither during that period nor cumulatively on August 5, 20X5, when both the service inception date and the grant date occur. This is consistent with the definition of requisite service period, which states that if an award requires future service for vesting,[78] the entity cannot define a prior period as the requisite service period.

A82. If the service inception date precedes the grant date, recognition of compensation cost for periods before the grant date shall be based on the fair value of the award at the reporting dates that occur prior to the grant date. In the period in which the grant date occurs, cumulative compensation cost shall be adjusted to reflect the cumulative effect of measuring compensation cost based on the fair value at the grant date rather than the fair value previously used at the service inception date (or any subsequent reporting dates) (paragraph 41).

A83. If an award's terms do not include a substantive future requisite service condition that exists at the grant date, the service inception date can precede the grant date. For example, on January 1, 20X5, an employee is informed that an award of 100 fully vested options will be made on January 1, 20X6, with an exercise price equal to the share price on January 1, 20X6. All approvals for that award have been obtained as of January 1, 20X5. That individual is still an employee on January 1, 20X6, and receives the 100 fully vested options on that date. There is no substantive future service period associated with the options after January 1, 20X6. Therefore, the requisite service period is from the January 1, 20X5 service inception date through the January 1, 20X6

[78]Future service in this context represents the service to be rendered beginning as of the service inception date.

grant date, as that is the period during which the employee is required to perform service in exchange for the award. The relationship between the exercise price and the current share price that provides a sufficient basis to understand the equity relationship established by the award is known on January 1, 20X6. Compensation cost would be recognized during 20X5 in accordance with paragraph A82.

A84. If an award contains either a market or a performance condition, which if not satisfied during the service period preceding the grant date and following the date the award is given results in a forfeiture of the award, then the service inception date may precede the grant date. For example, an authorized award is given on January 1, 20X5, with a two-year cliff vesting service requirement commencing on that date. The exercise price will be set on January 1, 20X6. The award will be forfeited if Entity T does not sell 1,000 units of product X in 20X5. In this example, the employee earns the right to retain the award if the performance condition is met and the employee renders service in 20X5 and 20X6. The requisite service period is two years beginning on January 1, 20X5. The service inception date (January 1, 20X5) precedes the grant date (January 1, 20X6). Compensation cost would be recognized during 20X5 in accordance with paragraph A82.

A85. In contrast, consider an award that is given on January 1, 20X5, with only a three-year cliff vesting explicit service condition, which commences on that date. The exercise price will be set on January 1, 20X6. In this example, the service inception date cannot precede the grant date because there is a substantive future requisite service condition that exists at the grant date (two years of service). Therefore, there would be no attribution of compensation cost for the period between January 1, 20X5, and December 31, 20X5, neither during that period nor cumulatively on January 1, 20X6, when both the service inception date and the grant date occur. This is consistent with the definition of requisite service period, which states that if an award requires future service for vesting, the entity cannot define a prior period as the requisite service period. The requisite service period would be two years, commencing on January 1, 20X6.

Illustration 4—Accounting for Share Options with Service Conditions

Illustration 4(a)—Share Options with Cliff Vesting

A86. Entity T, a public entity, grants at-the-money employee share options with a contractual term of 10 years. All share options vest at the end of three years (cliff vesting), which is an explicit service (and requisite service) period of three years. The share options do not qualify as incentive stock options for U.S. tax purposes. The enacted tax rate is 35 percent.

A87. The following table shows assumptions and information about the share options granted on January 1, 20X5.

Share options granted	900,000
Employees granted options	3,000
Expected forfeitures per year	3.0%
Share price at the grant date	$30
Exercise price	$30
Contractual term (CT) of options	10 years
Risk-free interest rate over CT	1.5 to 4.3%
Expected volatility over CT	40 to 60%
Expected dividend yield over CT	1.0%
Suboptimal exercise factor[79]	2

A88. This example assumes that each employee receives an equal grant of 300 options. Using as inputs the last 7 items from the table above, Entity T's lattice-based valuation model produces a fair value of $14.69 per option. A lattice model uses a suboptimal exercise factor to calculate the expected term (that is, the expected term is an output) rather than the expected term being a separate input. If an entity uses a Black-Scholes-Merton option-pricing formula, the expected term would be used as an input instead of a suboptimal exercise factor.

A89. Total compensation cost recognized over the requisite service period (which is the vesting period in this example) should be the grant-date fair value of all share options that actually vest (that is, all options for which the requisite service is rendered). Paragraph 43 of this Statement requires an entity to estimate at the grant date the number of share options for which the requisite service is expected to be rendered (which, in this illustration, is the number of share options for which vesting is deemed probable [80]). If

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[79]A suboptimal exercise factor of two means that exercise is generally expected to occur when the share price reaches two times the share option's exercise price. Option-pricing theory generally holds that the optimal (or profit-maximizing) time to exercise an option is at the end of the option's term; therefore, if an option is exercised prior to the end of its term, that exercise is referred to as *suboptimal.* Suboptimal exercise also is referred to as *early exercise.* Suboptimal or early exercise affects the expected term of an option. Early exercise can be incorporated into option-pricing models through various means. In this illustration, Entity T has sufficient information to reasonably estimate early exercise and has incorporated it as a function of Entity T's future stock price changes (or the option's intrinsic value). In this case, the factor of 2 indicates that early exercise would be expected to occur, on average, if the stock price reaches $60 per share ($30 × 2). Rather than use its weighted average suboptimal exercise factor, Entity T also may use multiple factors based on a distribution of early exercise data in relation to its stock price.

[80]Refer to paragraph A62, footnote 72.

that estimate changes, it shall be accounted for as a change in estimate and its cumulative effect (from applying the change retrospectively) recognized in the period of change. Entity T estimates at the grant date the number of share options expected to vest and subsequently adjusts compensation cost for changes in the estimated rate of forfeitures and differences between expectations and actual experience. This illustration assumes that none of the compensation cost is capitalized as part of the cost of an asset.

A90. The estimate of the number of forfeitures considers historical employee turnover rates and expectations about the future. Entity T has experienced historical turnover rates of approximately 3 percent per year for employees at the grantees' level, and it expects that rate to continue over the requisite service period of the awards. Therefore, at the grant date Entity T estimates the total compensation cost to be recognized over the requisite service period based on an expected forfeiture rate of 3 percent per year. Actual forfeitures are 5 percent in 20X5, but no adjustments to cumulative compensation cost are recognized in 20X5 because Entity T still expects actual forfeitures to average 3 percent per year over the 3-year vesting period. At December 31, 20X6, management decides that the forfeiture rate will likely increase through 20X7 and changes its estimated forfeiture rate for the entire award to 6 percent per year. Adjustments to cumulative compensation cost to reflect the higher forfeiture rate are made at the end of 20X6. At the end of 20X7 when the award becomes vested, actual forfeitures have averaged 6 percent per year, and no further adjustment is necessary.

A91. The first set of calculations illustrates the accounting for the award of share options on January 1, 20X5, assuming that the share options granted vest at the end of three years. (Paragraphs A97–A104 illustrate the accounting for an award assuming graded vesting in which a specified portion of the share options granted vest at the end of each year.) The number of share options expected to vest is estimated at the grant date to be 821,406 ($900{,}000 \times .97^3$). Thus, as shown in Table 1, the compensation cost to be recognized over the requisite service period at January 1, 20X5, is $12,066,454 (821,406 × $14.69), and the compensation cost to be recognized during each year of the 3-year vesting period is

$4,022,151 ($12,066,454 ÷ 3). The journal entries to recognize compensation cost and related deferred tax benefit at the enacted tax rate of 35 percent are as follows for 20X5:[81]

Compensation cost	$4,022,151	
Additional paid-in capital		$4,022,151
To recognize compensation cost.		

Deferred tax asset	$1,407,753	
Deferred tax benefit		$1,407,753

To recognize the deferred tax asset for the temporary difference related to compensation cost ($4,022,151 × .35 = $1,407,753).

The net after-tax effect on income of recognizing compensation cost for 20X5 is $2,614,398 ($4,022,151 – $1,407,753).

A92. Absent a change in estimated forfeitures, the same journal entries would be made to recognize compensation cost and related tax effects for 20X6 and 20X7, resulting in a net after-tax cost for each year of $2,614,398. However, at the end of 20X6, management changes its estimated employee forfeiture rate from 3 percent to 6 percent per year. The revised number of share options expected to vest is 747,526 (900,000 × $.94^3$). Accordingly, the revised cumulative compensation cost to be recognized by the end of 20X7 is $10,981,157 (747,526 × $14.69). The cumulative adjustment to reflect the effect of adjusting the forfeiture rate is the difference between two-thirds of the revised cost of the award and the cost already recognized for 20X5 and 20X6. The related journal entries and the computations follow.

[81]In this example, Entity T has concluded that it will have sufficient future taxable income to realize the deferred tax benefits from its share-based payment transactions.

At December 31, 20X6, to adjust for new forfeiture rate:

Revised total compensation cost	$10,981,157
Revised cumulative cost as of December 31, 20X6 ($10,981,157 × ⅔)	$ 7,320,771
Cost already recognized in 20X5 and 20X6 ($4,022,151 × 2)	8,044,302
Adjustment to cost at December 31, 20X6	$ (723,531)

The related journal entries are:

Additional paid-in capital	$723,531	
Compensation cost		$723,531

To adjust previously recognized compensation cost and equity to reflect a higher estimated forfeiture rate.

Deferred tax expense	$253,236	
Deferred tax asset		$253,236

To adjust the deferred tax accounts to reflect the tax effect of increasing the estimated forfeiture rate ($723,531 × .35 = $253,236).

For 20X7:

Compensation cost	$3,660,386	
Additional paid-in capital		$3,660,386

To recognize compensation cost ($10,981,157 ÷ 3 = $3,660,386).

Deferred tax asset	$1,281,135	
Deferred tax benefit		$1,281,135

To recognize the deferred tax asset for additional compensation cost ($3,660,386 × .35 = $1,281,135).

At December 31, 20X7, the entity would examine its actual forfeitures and make any necessary adjustments to reflect cumulative compensation cost for the number of shares that actually vested.

Table 1—Share Option—Cliff Vesting

Year	Total Value of Award	Pretax Cost for Year	Cumulative Pretax Cost
20X5	$12,066,454 (821,406 × $14.69)	$4,022,151 ($12,066,454 ÷ 3)	$4,022,151
20X6	$10,981,157 (747,526 × $14.69)	$3,298,620 [($10,981,157 × ⅔) – $4,022,151]	$7,320,771
20X7	$10,981,157 (747,526 × $14.69)	$3,660,386 ($10,981,157 ÷ 3)	$10,981,157

A93. All 747,526 vested share options are exercised on the last day of 20Y2. Entity T has already recognized its income tax expense for the year without regard to the effects of the exercise of the employee share options. In other words, current tax expense and current taxes payable were recognized based on income and deductions before consideration of additional deductions from exercise of the employee share options. Upon exercise, the amount credited to common stock (or other appropriate equity accounts) is the sum of the cash proceeds received and the amounts previously credited to additional paid-in capital in the periods the services were received (20X5 through 20X7). In this example, Entity T has no-par common stock and at exercise, the share price is assumed to be $60.

At exercise:

Cash (747,526 × $30)	$22,425,780	
Additional paid-in capital	$10,981,157	
Common stock		$33,406,937

To recognize the issuance of common stock upon exercise of share options and to reclass previously recorded paid-in capital.

Income Taxes

A94. In this example, the difference between the market price of the shares and the exercise price on the date of exercise is deductible for tax purposes pursuant to U.S. tax law in effect at the date of this Statement's issuance (the share options do not qualify as incentive stock options). Realized benefits of tax return deductions in excess of compensation cost recognized are accounted for as a credit to additional paid-in capital.[82] With the share price of $60 at exercise, the deductible amount is $22,425,780 [747,526 × ($60 – $30)]. Entity T has sufficient taxable income to fully realize that deduction, and the tax benefit realized is $7,849,023 ($22,425,780 × .35).

[82]A share option exercise may result in a tax deduction prior to the actual realization of the related tax benefit because the entity, for example, has a net operating loss carryforward. In that situation, a tax benefit and a credit to additional paid-in capital for the excess deduction would not be recognized until that deduction reduces taxes payable.

At exercise:

Deferred tax expense	$3,843,405	
Deferred tax asset		$3,843,405

To write off the deferred tax asset related to deductible share options at exercise ($10,981,157 × .35 = $3,843,405).

Current taxes payable	$7,849,023	
Current tax expense		$3,843,405
Additional paid-in capital		$4,005,618

To adjust current tax expense and current taxes payable to recognize the current tax benefit from deductible compensation cost upon exercise of share options.

The credit to additional paid-in capital is the tax benefit of the excess of the deductible amount over the recognized compensation cost [($22,425,780 – $10,981,157) × .35 = $4,005,618].

A95. If instead the share options expired unexercised, previously recognized compensation cost would not be reversed. There would be no deduction on the tax return and, therefore, the entire deferred tax asset of $3,843,405 would be charged to income tax expense[83] or additional paid-in capital, to the extent of any remaining additional paid-in capital from excess tax benefits from previous awards accounted for in accordance with this Statement or Statement 123 (paragraph 63).[84]

Cash Flows from Income Taxes

A96. FASB Statement No. 95, *Statement of Cash Flows,* as amended by this Statement, requires that the realized tax benefit related to the excess of the deductible amount over the compensation cost recognized be classified in the statement of cash flows as a cash inflow from financing activities and a cash outflow from operating activities. Under either the direct or indirect method of reporting cash flows, Entity T

[83]If employees terminated with out-of-the-money vested share options, the deferred tax asset related to those share options would be written-off when those options expire.

[84]A write-off of a deferred tax asset related to a deficiency of deductible compensation cost in relation to recognized compensation cost for financial reporting purposes shall not be reflected in the statement of cash flows because the unit of account for cash-flow purposes is an individual award (or portion thereof) as opposed to a portfolio of awards.

would disclose the following activity in its statement of cash flows for the year ended December 31, 20Y2:

Cash outflow from operating activities:	
Excess tax benefits from share-based payment arrangements	$(4,005,618)
Cash inflow from financing activities:	
Excess tax benefits from share-based payment arrangements	$4,005,618

Illustration 4(b)—Share Options with Graded Vesting

A97. Paragraph 42 of this Statement provides for the following two methods to recognize compensation cost for awards with graded vesting: (a) on a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in-substance, multiple awards (graded vesting attribution method) or (b) on a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award), subject to the limitation noted in paragraph 42.[85] The accounting is illustrated below for both methods and uses the same assumptions as those noted in paragraphs A86–A88 except for the vesting provisions.

A98. Entity T awards 900,000 share options on January 1, 20X5, that vest according to a graded schedule of 25 percent for the first year of service, 25 percent for the second year, and the remaining 50 percent for the third year. Each employee is granted 300 share options. Table 2 shows the calculation as of January 1, 20X5, of the number of employees and the related number of share options expected to vest. Using the expected 3 percent annual forfeiture rate, 90 employees are expected to terminate during 20X5 without having vested in any portion of the award, leaving 2,910 employees to vest in 25 percent of the award (75 options). During 20X6, 87 employees are expected to terminate, leaving 2,823 to vest in the second 25 percent of the award. During 20X7, 85 employees are expected to terminate, leaving 2,738 employees to vest in the last 50 percent of the award. That results in a total of 840,675 share options expected to vest from the award of 900,000 share options with graded vesting.

[85]The choice of attribution method for awards with graded vesting schedules is a policy decision that is not dependent on an enterprise's choice of valuation technique. In addition, the choice of attribution method applies to awards with only service conditions.

Table 2—Share Option—Graded Vesting—Estimated Amounts

Year	Number of Employees	Number of Vested Share Options
	Total at date of grant 3,000	
20X5	3,000 – 90 (3,000 × .03) = 2,910	2,910 × 75 (300 × 25%) = 218,250
20X6	2,910 – 87 (2,910 × .03) = 2,823	2,823 × 75 (300 × 25%) = 211,725
20X7	2,823 – 85 (2,823 × .03) = 2,738	2,738 × 150 (300 × 50%) = 410,700
		Total vested options 840,675

Graded Vesting Attribution Method

A99. The value of the share options that vest over the three-year period is estimated by separating the total award into three groups (or tranches) according to the year in which they vest (because the expected life for each tranche differs). Table 3 shows the estimated compensation cost for the share options expected to vest. The estimates of expected volatility, expected dividends, and risk-free interest rates are incorporated into the lattice, and the graded vesting conditions affect only the earliest date at which suboptimal exercise can occur. Thus, the fair value of each of the 3 groups of options is based on the same lattice inputs for expected volatility, expected dividend yield, and risk-free interest rates used to determine the value of $14.69 for the cliff-vesting share options (paragraphs A87 and A88). The different vesting terms affect the ability of the suboptimal exercise to occur sooner (and affect other factors as well, such as volatility), and therefore there is a different expected term for each tranche.

Table 3—Share Option—Graded Vesting—Estimated Cost

Year	Vested Options	Value per Option	Compensation Cost
20X5	218,250	$13.44	$ 2,933,280
20X6	211,725	14.17	3,000,143
20X7	410,700	14.69	6,033,183
	840,675		$11,966,606

A100. Compensation cost is recognized over the periods of requisite service during which each tranche of share options is earned. Thus, the $2,933,280 cost attributable to the 218,250 share options that vest in 20X5 is recognized in 20X5. The $3,000,143 cost attributable to the 211,725 share options that vest at the end of 20X6 is recognized over the 2-year vesting period (20X5 and 20X6). The $6,033,183 cost attributable to the 410,700 share options that vest at the end of 20X7 is recognized over the 3-year vesting period (20X5, 20X6, and 20X7).

A101. Table 4 shows how the $11,966,606 expected amount of compensation cost determined at the grant date is attributed to the years 20X5, 20X6, and 20X7.

Table 4—Share Option—Graded Vesting—Computation of Estimated Cost

	Pretax Cost to Be Recognized		
	20X5	**20X6**	**20X7**
Share options vesting in 20X5	$2,933,280		
Share options vesting in 20X6	1,500,071	$1,500,072	
Share options vesting in 20X7	2,011,061	2,011,061	$ 2,011,061
Cost for the year	$6,444,412	$3,511,133	$ 2,011,061
Cumulative cost	$6,444,412	$9,955,545	$11,966,606

Straight-Line Attribution Method

A102. Entity T could use the same computation of estimated cost, as in Table 3 above, but could elect to recognize compensation cost on a straight-line basis for all graded vesting awards. In that case, total compensation cost to be attributed on a straight-line basis over each year in the 3-year vesting period is approximately $3,988,868 ($11,966,606 ÷ 3).[86] However, this Statement requires that compensation cost recognized at any date must be at least equal to the amount attributable to options that are vested at that date. For example, if 50 percent of this same option award vested in the first year of the 3-year vesting period, $5,983,303 ($11,966,606 ÷ 2) would be recognized in the first year.

A103. Compensation cost is adjusted for awards with graded vesting to reflect differences between estimated and actual forfeitures as illustrated for the cliff-vesting options, regardless of which method is used to estimate value and attribute cost.

A104. Accounting for the tax effects of awards with graded vesting follows the same pattern illustrated in paragraphs A94 and A95. However, unless Entity T identifies and tracks the specific tranche from which share options are exercised, it would not know the recognized compensation cost that corresponds to exercised share options for purposes of calculating the tax effects resulting from that exercise. If an entity does not know the specific tranche from which share options are exercised, it should assume that options are exercised on a first-vested, first-exercised basis (which works in the same manner as the first-in, first-out basis for inventory costing).

[86]Entity T also could use a single weighted-average expected life to value the entire award and arrive at a different amount of total compensation cost. Total compensation cost could then be attributed on a straight-line basis over the three-year vesting period.

Illustration 5—Share Option with Multiple Performance Conditions

Illustration 5(a)—Share Option Award under Which the Number of Options to Be Earned Varies

A105. Illustration 5(a) shows the computation of compensation cost if Entity T grants an award of share options with multiple performance conditions. Under the award, employees vest in differing numbers of options depending on the amount by which the market share of one of Entity T's products increases over a three-year period (the share options cannot vest before the end of the three-year period). The three-year explicit service period represents the requisite service period. On January 1, 20X5, Entity T grants to each of 1,000 employees an award of up to 300 10-year-term share options on its common stock. If market share increases by at least 5 percentage points by December 31, 20X7, each employee vests in at least 100 share options at that date. If market share increases by at least 10 percentage points, another 100 share options vest, for a total of 200. If market share increases by more than 20 percentage points, each employee vests in all 300 share options. Entity T's share price on January 1, 20X5, is $30 and other assumptions are the same as in Illustration 4(a) (paragraph A87). The grant-date fair value per share option is $14.69.[87] The compensation cost of the award depends on the estimated number of options that will vest. Entity T must determine whether it is probable[88] that any performance condition will be achieved, that is, whether the growth in market share over the 3-year period will be at least 5 percent. Accruals of compensation cost are initially based on the probable outcome of the performance conditions—in this case, different levels of market share growth over the three-year vesting period—and adjusted for subsequent changes in the estimated or actual outcome. If Entity T determines that no performance condition is probable of achievement (that is, market share growth is expected to be less than 5 percentage points), then no compensation cost is recognized; however, Entity T is required to reassess at each reporting date whether achievement of any performance condition is probable and would begin recognizing compensation cost if and when achievement of a performance condition becomes probable.

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[87]While the vesting conditions in this illustration and Illustration 4 are different, the equity instruments being valued have the same estimate of grant-date fair value. That is a consequence of the modified grant-date method, which accounts for the effects of vesting requirements or other restrictions that apply during the vesting period by recognizing compensation cost only for the instruments that actually vest. (This discussion does not refer to awards with market conditions that affect exercisability or the ability to retain the award as described in paragraphs A49–A51.)

[88]*Probable* is used in the same sense as in Statement 5: "the future event or events are likely to occur" (paragraph 3).

A106. Paragraph 44 of this Statement requires accruals of cost to be based on the probable outcome of performance conditions. Accordingly, this Statement prohibits Entity T from basing accruals of compensation cost on an amount that is not a possible outcome (and thus cannot be the probable outcome). For instance, if Entity T estimates that there is a 90 percent, 30 percent, and 10 percent likelihood that market share growth will be at least 5 percentage points, at least 10 percentage points, and greater than 20 percentage points, respectively, it would not try to determine a weighted average of the possible outcomes because that number of shares is not a possible outcome under the arrangement.

A107. Table 5 shows the compensation cost that would be recognized in 20X5, 20X6, and 20X7 if Entity T estimates at the grant date that it is probable that market share will increase at least 5 but less than 10 percentage points (that is, each employee would receive 100 share options). That estimate remains unchanged until the end of 20X7, when Entity T's market share has increased over the 3-year period by more than 10 percentage points. Thus, each employee vests in 200 share options.

A108. As in Illustration 4(a) (refer to paragraph A90), Entity T experiences actual forfeiture rates of 5 percent in 20X5, and in 20X6 changes its estimate of forfeitures for the entire award from 3 percent to 6 percent per year. In 20X6, cumulative compensation cost is adjusted to reflect the higher forfeiture rate. By the end of 20X7, a 6 percent forfeiture rate has been experienced, and no further adjustments for forfeitures are necessary. Through 20X5, Entity T estimates that 913 employees ($1,000 \times .97^3$) will remain in service until the vesting date. At the end of 20X6, the number of employees estimated to remain in service is adjusted for the higher forfeiture rate, and the number of employees estimated to remain in service is 831 ($1,000 \times .94^3$). The compensation cost of the award is initially estimated based on the number of options expected to vest, which in turn is based on the expected level of performance and the fair value of each option.[89] The amount of compensation cost recognized (or attributed) when achievement of a performance condition is probable depends on the relative satisfaction of the performance condition based on performance to date. Entity T determines that recognizing compensation cost ratably over the three-year vesting period is appropriate with one-third of the value of the award recognized each year.

[89]That amount would be adjusted as needed for changes in the estimated and actual forfeiture rates and for differences between estimated and actual market share growth.

**Table 5—Share Option with Performance Condition—
Number of Share Options Varies**

Year	Total Value of Award	Pretax Cost for Year	Cumulative Pretax Cost
20X5	$1,341,197 ($14.69 × 100 × 913)	$447,066 ($1,341,197 ÷ 3)	$447,066
20X6	$1,220,739 ($14.69 × 100 × 831)	$366,760 [($1,220,739 × ⅔) – $447,066]	$813,826
20X7	$2,441,478 ($14.69 × 200 × 831)	$1,627,652 ($2,441,478 – $813,826)	$2,441,478

Illustration 5(b)—Share Option Award under Which the Exercise Price Varies

A109. Illustration 5(b) shows the computation of compensation cost if Entity T grants a share option award with a performance condition under which the exercise price, rather than the number of shares, varies depending on the level of performance achieved. On January 1, 20X5, Entity T grants to its CEO 10-year share options on 10,000 shares of its common stock, which are immediately vested and exercisable (an explicit service period of zero). The share price at the grant date is $30, and the initial exercise price also is $30. However, that price decreases to $15 if the market share for Entity T's products increases by at least 10 percentage points by December 31, 20X6, and provided that the CEO continues to be employed by Entity T and has not previously exercised the options (an explicit service period of 2 years, which also is the requisite service period).

A110. Entity T estimates at the grant date the expected level of market share growth, the exercise price of the options, and the expected term of the options. Other assumptions, including the risk-free interest rate and the service period over which the cost is attributed, are consistent with those estimates. Entity T estimates at the grant date that its market share growth will be at least 10 percentage points over the 2-year performance period, which means that the expected exercise price of the share options is $15, resulting in a fair value of $19.99 per option.[90] Total compensation cost to be recognized if the performance condition is satisfied would be $199,900 (10,000 × $19.99). Paragraph 49 of this Statement requires that the fair value of both awards with service conditions and awards with performance conditions be estimated as of the date of grant. Paragraph 43 of this Statement also requires recognition of cost for the number of instruments for which the requisite service is provided. For this performance award, Entity T also selects the expected assumptions at the grant date if the performance goal is not met. If market share growth is not at least 10 percentage points

[90]Option value is determined using the same assumptions noted in paragraph A87 except the exercise price is $15 and the award is not exercisable at $15 per option for 2 years.

over the 2-year period, Entity T estimates a fair value of $13.08 per option.[91] Total compensation cost to be recognized if the performance goal is not met would be $130,800 (10,000 × $13.08). Because Entity T estimates that the performance condition would be satisfied, it would recognize compensation cost of $130,800 on the date of grant related to the fair value of the fully vested award and recognize compensation cost of $69,100 ($199,900 – $130,800) over the 2-year requisite service period related to the condition.[92] During the two-year requisite service period, adjustments to reflect any change in estimate about satisfaction of the performance condition should be made, and, thus, aggregate cost recognized by the end of that period reflects whether the performance goal was met.

Illustration 6—Other Performance Conditions

A111. While performance conditions usually affect vesting conditions, they may affect exercise price, contractual term, quantity, or other factors that affect an award's fair value prior to, at the time of, or subsequent to vesting. This Statement requires that all performance conditions be accounted for similarly. A potential grant-date fair value is estimated for each of the possible outcomes that are reasonably determinable at the grant date and associated with the performance condition(s) of the award (as demonstrated in Illustration 5(b), paragraphs A109 and A110). Compensation cost ultimately recognized is equal to the grant-date fair value of the award that coincides with the actual outcome of the performance condition(s).

A112. To illustrate the notion described in paragraph A111 and attribution of compensation cost when performance conditions have different service periods, assume Entity C grants 10,000 at-the-money share options on its common stock to an employee. The options have a 10-year contractual term. The share options vest upon successful completion of phase-two clinical trials to satisfy regulatory testing requirements related to a developmental drug therapy. Phase-two clinical trials are scheduled to be completed (and regulatory approval of that phase obtained) in approximately 18 months; hence, the implicit service period is approximately 18 months. Further, the share options will become fully transferable upon regulatory approval of the drug therapy (which is scheduled to occur in approximately four years). The implicit service period for that performance condition is approximately 30 months (beginning once phase-two clinical trials are successfully completed). Based on the nature of the

[91]Option value is determined using the same assumptions noted in paragraph A87 except the award is immediately vested.

[92]Because of the nature of the performance condition, the award has multiple requisite service periods that affect the manner in which compensation cost is attributed. Paragraphs A55–A74 provide guidance on estimating the requisite service period.

performance conditions, the award has multiple requisite service periods (one pertaining to each performance condition) that affect the pattern in which compensation cost is attributed.[93] The determination of whether compensation cost should be recognized depends on Entity C's assessment of whether the performance conditions are probable of achievement. Entity C expects that all performance conditions will be achieved. That assessment is based on the relevant facts and circumstances, including Entity C's historical success rate of bringing developmental drug therapies to market.

A113. At the grant date, Entity C estimates that the potential fair value of each share option under the 2 possible outcomes is $10 (Outcome 1, in which the share options vest and do not become transferable) and $16 (Outcome 2, in which the share options vest and do become transferable).[94] If Outcome 1 is considered probable of occurring, Entity C would recognize $100,000 (10,000 × $10) of compensation cost ratably over the 18-month requisite service period related to the successful completion of phase-two clinical trials. If Outcome 2 is considered probable of occurring, then Entity C would recognize an additional $60,000 [10,000 × ($16 – $10)] of compensation cost ratably over the 30-month requisite service period (which begins after phase-two clinical trials are successfully completed) related to regulatory approval of the drug therapy. Because Entity C believes that Outcome 2 is probable, it recognizes compensation cost in the pattern described. However, if circumstances change and it is determined at the end of year three that the regulatory approval of the developmental drug therapy is likely to be obtained in six years rather than four, the requisite service period for Outcome 2 is revised, and the remaining unrecognized compensation cost would be recognized prospectively through year six. On the other hand, if it becomes probable that Outcome 2 will not occur, compensation cost recognized for Outcome 2, if any, would be reversed.

Illustration 7—Share Option with a Market Condition (Indexed Exercise Price)

A114. Entity T grants share options whose exercise price varies with an index of the share prices of a group of entities in the same industry, that is, a market condition as defined in this Statement (refer to Appendix E). Assume that on January 1, 20X5, Entity T grants 100 share options on its common stock with an initial exercise price of $30 to each of 1,000 employees. The share options have a maximum term of 10 years. The exercise price of the share options increases or decreases on December 31 of each year

[93]Paragraphs A55–A74 provide guidance on estimating the requisite service period of an award.

[94]The difference in estimated fair values of each outcome is due to the change in estimate of the expected term of the share option. Outcome 1 uses an expected term in estimating fair value that is less than the expected term used for Outcome 2, which is equal to the award's 10-year contractual term. If a share option is transferable, its expected term is equal to its contractual term (paragraph A26).

by the same percentage that the index has increased or decreased during the year. For example, if the peer group index increases by 10 percent in 20X5, the exercise price of the share options during 20X6 increases to $33 ($30 × 1.10). On January 1, 20X5, the peer group index is assumed to be 400. The dividend yield on the index is assumed to be 1.25 percent.

A115. Each indexed share option may be analyzed as a share option to exchange 0.0750 (30 ÷ 400) "shares" of the peer group index for a share of Entity T stock—that is, to exchange one noncash asset for another noncash asset. A share option to purchase stock for cash also can be thought of as a share option to exchange one asset (cash in the amount of the exercise price) for another (the share of stock). The intrinsic value of a cash share option equals the difference between the price of the stock upon exercise and the amount—the price—of the cash exchanged for the stock. The intrinsic value of a share option to exchange 0.0750 "shares" of the peer group index for a share of Entity T stock also equals the difference between the prices of the two assets exchanged.

A116. To illustrate the equivalence of an indexed share option and the share option above, assume that an employee exercises the indexed share option when Entity T's share price has increased 100 percent to $60 and the peer group index has increased 75 percent, from 400 to 700. The exercise price of the indexed share option thus is $52.50 ($30 × 1.75).

Price of Entity T share	$60.00
Less: Exercise price of share option	52.50
Intrinsic value of indexed share option	$ 7.50

That is the same as the intrinsic value of a share option to exchange 0.0750 shares of the index for 1 share of Entity T stock:

Price of Entity T share	$60.00
Less: Price of a share of the peer group index (.0750 × $700)	52.50
Intrinsic value at exchange	$ 7.50

A117. Option-pricing models can be extended to value a share option to exchange one asset for another. The principal extension is that the volatility of a share option to exchange two noncash assets is based on the relationship between the volatilities of the prices of the assets to be exchanged—their **cross-volatility.** In a share option with an exercise price payable in cash, the amount of cash to be paid has zero volatility, so only the volatility of the stock needs to be considered in estimating that option's fair value. In contrast, the fair value of a share option to exchange two noncash assets depends on possible movements in the prices of both assets—in this example, fair value depends

on the cross-volatility of a share of the peer group index and a share of Entity T stock. Historical cross-volatility can be computed directly based on measures of Entity T's share price in shares of the peer group index. For example, Entity T's share price was 0.0750 shares at the grant date and 0.0857 (60 ÷ 700) shares at the exercise date. Those share amounts then are used to compute cross-volatility. Cross-volatility also can be computed indirectly based on the respective volatilities of Entity T stock and the peer group index and the correlation between them. The expected cross-volatility between Entity T stock and the peer group index is assumed to be 30 percent.

A118. In a share option with an exercise price payable in cash, the assumed risk-free interest rate (discount rate) represents the return on the cash that will not be paid until exercise. In this example, an equivalent share of the index, rather than cash, is what will not be "paid" until exercise. Therefore, the dividend yield on the peer group index of 1.25 percent is used in place of the risk-free interest rate as an input to the option-pricing model.

A119. The initial exercise price for the indexed share option is the value of an equivalent share of the peer group index, which is $30 (0.0750 × $400). The fair value of each share option granted is $7.55 based on the following inputs:

Share price	$30
Exercise price	$30
Dividend yield	1.00%
Discount rate	1.25%
Volatility	30%
Contractual term	10 years
Suboptimal exercise factor[95]	1.10

A120. The indexed share options have a three-year explicit service period. The market condition affects the grant-date fair value of the award and its exercisability; however, vesting is based solely on the explicit service period of three years. The at-the-money nature of the award makes the derived service period irrelevant in determining the requisite service period in this example; therefore, the requisite service period of the award is three years based on the explicit service period. The accrual of compensation cost would be based on the number of options for which the requisite service is expected to be rendered (which is not addressed in this illustration). That cost would be recognized over the requisite service period as shown in Illustration 4(a) (paragraphs A86–A96).

[95]Refer to paragraph A87, footnote 79.

Illustration 8—Share Unit with Performance and Market Conditions

A121. Entity T grants 100,000 share units (SUs) to each of 10 vice presidents (VPs) (1 million SUs in total) on January 1, 20X5. Each SU has a contractual term of three years and a vesting condition based on performance. The performance condition is different for each VP and is based on specified goals to be achieved over three years (an explicit three-year service period). If the specified goals are not achieved at the end of three years, the SUs will not vest. Each SU is convertible into shares of Entity T at contractual maturity as follows: (a) if Entity T's share price has appreciated by a percentage that exceeds the percentage appreciation of the S&P 500 index by at least 10 percent (that is, the relative percentage increase is at least 10 percent), each SU converts into 3 shares of Entity T stock, (b) if the relative percentage increase is less than 10 percent but greater than zero percent, each SU converts into 2 shares of Entity T stock, (c) if the relative percentage increase is less than or equal to zero percent, each SU converts into 1 share of Entity T stock, and (d) if Entity T's share price has depreciated, each SU converts into zero shares of Entity T stock.[96] Appreciation or depreciation for Entity T's share price and the S&P 500 index is measured from the grant date.

A122. The SUs' conversion feature is based on a variable target stock price (that is, the target stock price varies based on the S&P 500 index); hence, it is a market condition. That market condition affects the fair value of the SUs that vest. Each VP's SUs vest only if the individual's performance condition is achieved; consequently, this award is accounted for as an award with a performance condition (paragraphs A49–A51). This example assumes that all SUs become fully vested; however, if the SUs do not vest because the performance conditions are not achieved, Entity T would reverse any previously recognized compensation cost associated with the nonvested SUs.

A123. The grant-date fair value of each SU is assumed for purposes of this example to be $36.[97] For simplicity, this example assumes that no forfeitures will occur during the vesting period. The grant-date fair value of the award is $36 million (1 million ×

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[96]This market condition affects the ability to retain the award because the conversion ratio could be zero; however, vesting is based solely on the explicit service period of three years, which is equal to the contractual maturity of the award. That set of circumstances makes the derived service period irrelevant in determining the requisite service period; therefore, the requisite service period of the award is three years based on the explicit service period.

[97]Certain option-pricing models, including Monte Carlo simulation techniques, have been adapted to value path-dependent options and other complex instruments. In this case, the entity concludes that a Monte Carlo simulation technique provides a reasonable estimate of fair value. Each simulation represents a potential outcome, which determines whether an SU would convert into three, two, one, or zero shares of stock.

$36); management of Entity T expects that all SUs will vest because the performance conditions are probable of achievement. Entity T recognizes compensation cost of $12 million ($36 million ÷ 3) in each year of the 3-year service period; the following journal entries are recognized by Entity T in 20X5, 20X6, and 20X7:

Compensation cost	$12,000,000	
Additional paid-in capital		$12,000,000
To recognize compensation cost.		

Deferred tax asset	$4,200,000	
Deferred tax benefit		$4,200,000

To recognize the deferred tax asset for the temporary difference related to compensation cost ($12,000,000 × .35 = $4,200,000).

A124. Upon contractual maturity of the SUs, four outcomes are possible; however, because all possible outcomes of the market condition were incorporated into the SUs' grant-date fair value, no other entry related to compensation cost is necessary to account for the actual outcome of the market condition. However, if the SUs' conversion ratio was based on achieving a performance condition rather than on satisfying a market condition, compensation cost would be adjusted according to the actual outcome of the performance condition (refer to Illustration 6, paragraphs A111–A113).

Illustration 9—Share Option with Exercise Price That Increases by a Fixed Amount or a Fixed Percentage

A125. Some entities grant share options with exercise prices that increase by a fixed amount or a constant percentage periodically. For example, the exercise price of the share options in Illustration 4(a) (paragraphs A86–A96) might increase by a fixed amount of $2.50 per year. Lattice models and other valuation techniques can be adapted to accommodate exercise prices that change over time by a fixed amount.[98]

A126. Share options with exercise prices that increase by a constant percentage also can be valued using an option-pricing model that accommodates changes in exercise prices. Alternatively, those share options can be valued by deducting from the discount rate the annual percentage increase in the exercise price. That method works because a decrease in the risk-free interest rate and an increase in the exercise price have a similar effect—both reduce the share option value. For example, the exercise price of the share options in Illustration 4 might increase at the rate of 1 percent annually. For

[98]Such an arrangement has a market condition and may have a derived service period.

that example, Entity T's share options would be valued based on a risk-free interest rate less 1 percent. Holding all other assumptions constant from Illustration 4(a) (refer to paragraph A87), the value of each share option granted by Entity T would be $14.34.

Illustration 10—Share-Based Liability (Cash-Settled SARs)

A127. Entity T, a public company, grants share appreciation rights (SARs) with the same terms and conditions as those described in Illustration 4(a) (paragraphs A86–A88). Each SAR entitles the holder to receive an amount in cash equal to the increase in value of 1 share of Entity T stock over $30. Entity T determines the grant-date fair value of each SAR in the same manner as a share option and uses the same assumptions and option-pricing model used to estimate the fair value of the share options in Illustration 4(a); consequently, the grant-date fair value of each SAR is $14.69 (paragraphs A87–A88). The awards cliff-vest at the end of three years of service (an explicit and requisite service period of three years). The number of SARs for which the requisite service is expected to be rendered is estimated at the grant date to be 821,406 ($900{,}000 \times .97^3$). Thus, the fair value of the award at January 1, 20X5, is $12,066,454 (821,406 × $14.69). For simplicity, this example assumes that estimated forfeitures equal actual forfeitures.

A128. Paragraph 37 of this Statement requires that share-based compensation liabilities be recognized at fair value or a portion thereof (depending on the percentage of requisite service that has been rendered at the reporting date) and be remeasured at each reporting date through the date of settlement;[99] consequently, compensation cost recognized during each year of the three-year vesting period (as well as during each year thereafter through the date of settlement) will vary based on changes in the award's fair value. At December 31, 20X5, the assumed fair value is $10 per SAR; hence, the fair value of the award is $8,214,060 (821,406 × $10). The share-based compensation liability at December 31, 20X5, is $2,738,020 ($8,214,060 ÷ 3) to account for the portion of the award related to the service rendered in 20X5 (1 year of the 3-year requisite service period). For convenience, this example assumes that journal entries

[99]Paragraph 38 permits a nonpublic entity to measure share-based payment liabilities at either fair value (or, in some cases, calculated value) or intrinsic value. If a nonpublic entity elects to measure those liabilities at fair value, the accounting demonstrated in this illustration would be applicable.

to account for the award are performed at year-end. The journal entries for 20X5 are as follows:

Compensation cost	$2,738,020	
Share-based compensation liability		$2,738,020

To recognize compensation cost.

Deferred tax asset	$958,307	
Deferred tax benefit		$958,307

To recognize the deferred tax asset for the temporary difference related to compensation cost ($2,738,020 × .35 = $958,307).

A129. At December 31, 20X6, the fair value is assumed to be $25 per SAR; hence, the award's fair value is $20,535,150 (821,406 × $25), and the corresponding liability at that date is $13,690,100 ($20,535,150 × ⅔) because service has been provided for 2 years of the 3-year requisite service period. Compensation cost recognized for the award in 20X6 is $10,952,080 ($13,690,100 – $2,738,020). Entity T recognizes the following journal entries for 20X6:

Compensation cost	$10,952,080	
Share-based compensation liability		$10,952,080

To recognize a share-based compensation liability of $13,690,100 and associated compensation cost.

Deferred tax asset	$3,833,228	
Deferred tax benefit		$3,833,228

To recognize the deferred tax asset for additional compensation cost ($10,952,080 × .35 = $3,833,228).

A130. At December 31, 20X7, the fair value is assumed to be $20 per SAR; hence, the award's fair value is $16,428,120 (821,406 × $20), and the corresponding liability at that date is $16,428,120 ($16,428,120 × 1) because the award is fully vested. Compensation cost recognized for the liability award in 20X7 is $2,738,020

($16,428,120 – $13,690,100). Entity T recognizes the following journal entries for 20X7:

Compensation cost	$2,738,020	
Share-based compensation liability		$2,738,020

To recognize a share-based compensation liability of $16,428,120 and associated compensation cost.

Deferred tax asset	$958,307	
Deferred tax benefit		$958,307

To recognize the deferred tax asset for additional compensation cost ($2,738,020 × .35 = $958,307).

Table 6—Share-Based Liability Award

Year	Total Value of Award at Year-End	Pretax Cost for Year	Cumulative Pretax Cost
20X5	$8,214,060 (821,406 × $10)	$2,738,020 ($8,214,060 ÷ 3)	$2,738,020
20X6	$20,535,150 (821,406 × $25)	$10,952,080 [($20,535,150 × ⅔) – $2,738,020]	$13,690,100
20X7	$16,428,120 (821,406 × $20)	$2,738,020 ($16,428,120 – $13,690,100)	$16,428,120

A131. For simplicity, this illustration assumes that all of the SARs are exercised on the same day, that the liability award's fair value is $20 per SAR, and that Entity T has already recognized its income tax expense for the year without regard to the effects of the exercise of the employee SARs. In other words, current tax expense and current taxes payable were recognized based on taxable income and deductions before consideration of additional deductions from exercise of the SARs. The amount credited to cash for the exercise of the SARs is equal to the share-based compensation liability of $16,428,120.

At exercise:

Share-based compensation liability	$16,428,120	
Cash (821,406 × $20)		$16,428,120

To recognize the cash payment to employees from SAR exercise.

Income Taxes

A132. The cash paid to the employees on the date of exercise is deductible for tax purposes. Entity T has sufficient taxable income, and the tax benefit realized is $5,749,842 ($16,428,120 × .35).

At exercise:

Deferred tax expense	$5,749,842	
Deferred tax asset		$5,749,842

To write off the deferred tax asset related to the SARs.

Current taxes payable	$5,749,842	
Current tax expense		$5,749,842

To adjust current tax expense and current taxes payable to recognize the current tax benefit from deductible compensation cost.

A133. If the SARs had expired worthless, the share-based compensation liability account and deferred tax asset account would have been adjusted to zero through the income statement as the award's fair value decreased.

Illustration 11—Share-Based Equity and Liability Awards Granted by a Nonpublic Entity

Illustration 11(a)—Share Award Granted by a Nonpublic Entity

A134. On January 1, 20X6, Entity W, a nonpublic entity,[100] grants 100 shares of stock to each of its 100 employees. The shares cliff vest at the end of three years. Entity W estimates that the grant-date fair value of 1 share of stock is $7. The grant-date fair value of the share award is $70,000 (100 × 100 × $7). The fair value of shares, which is equal to its intrinsic value, is not subsequently remeasured. For simplicity, the example assumes that no forfeitures occur during the vesting period. Because the

[100]The accounting demonstrated in this illustration also would be applicable to a public entity that grants share awards to its employees. The same measurement method and basis is used for both nonvested share awards and restricted share awards (which are a subset of nonvested share awards).

requisite service period is three years, Entity W recognizes $23,333 ($70,000 ÷ 3) of compensation cost for each annual period as follows:

Compensation cost	$23,333	
Additional paid-in capital		$23,333
To recognize compensation cost.		

Deferred tax asset	$8,167	
Deferred tax benefit		$8,167

To recognize the deferred tax asset for the temporary difference related to compensation cost ($23,333 × .35 = $8,167).

Income Taxes

A135. After three years, all shares are vested. For simplicity, this illustration assumes that no employees made an IRS Code §83(b) election[101] and Entity W has already recognized its income tax expense for the year in which the shares become vested without regard to the effects of the share award.

A136. The fair value per share on the vesting date, assumed to be $20, is deductible for tax purposes. Paragraph 62 of this Statement requires that excess tax benefits be recognized as a credit to additional paid-in capital. Tax return deductions that are less than compensation cost recognized result in a charge to income tax expense in the period of vesting unless there are any remaining excess tax benefits from previous awards accounted for in accordance with this Statement or Statement 123, in which case, the amount of any tax deficiency is first offset against additional paid-in capital. With the share price at $20 on the vesting date, the deductible amount is $200,000 (10,000 × $20). The entity has sufficient taxable income, and the tax benefit realized is $70,000 ($200,000 × .35).

[101]IRS Code §83(b) permits an employee to elect either the grant date or the vesting date for measuring the fair market value of an award of shares.

At vesting:

Deferred tax expense	$24,500	
Deferred tax asset		$24,500

To write off deferred tax asset related to deductible share award at vesting ($70,000 × .35 = $24,500).

Current taxes payable	$70,000	
Current tax expense		$24,500
Additional paid-in capital		$45,500

To adjust current tax expense and current taxes payable to recognize the current tax benefit from deductible compensation cost upon vesting of share award. The credit to additional paid-in capital is the excess tax benefit: ($200,000 – $70,000) × .35 = $45,500.

Illustration 11(b)—Share Option Award Granted by a Nonpublic Entity That Uses the Calculated Value Method

A137. On January 1, 20X6, Entity W, a small nonpublic entity that develops, manufactures, and distributes medical equipment, grants 100 share options to each of its 100 employees. The share price at the grant date is $7.[102] The options are granted at-the-money, cliff vest at the end of 3 years, and have a 10-year contractual term. Entity W estimates the expected term of the share options granted as 5 years and the risk-free rate as 3.75 percent. For simplicity, the example assumes that no forfeitures occur during the vesting period and that no dividends are expected to be paid in the future, and the example does not reflect the accounting for income tax consequences of the awards.

A138. Entity W does not maintain an internal market for its shares, which are rarely traded privately. It has not issued any new equity or convertible debt instruments for several years and has been unable to identify any similar entities that are public. Entity W has determined that it is not practicable for it to estimate the expected volatility of its share price and, therefore, it is not possible for it to reasonably estimate the grant-date fair value of the share options. Accordingly, Entity W is required to apply the provisions of paragraph 23 of this Statement in accounting for the share options under the calculated value method.

[102]The AICPA Practice Aid, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation,* describes best practices for the valuation of privately-held-company equity securities issued as compensation.

A139. Entity W operates exclusively in the medical equipment industry. It visits the Dow Jones Indexes website and, using the Industry Classification Benchmark, reviews the various industry sector components of the Dow Jones U.S. Total Market Index. It identifies the medical equipment subsector, within the health care equipment and services sector, as the most appropriate industry sector in relation to its operations. It reviews the current components of the medical equipment index and notes that, based on the most recent assessment of its share price and its issued share capital, in terms of size it would rank among companies in the index with a small market capitalization (or *small-cap* companies). Entity W selects the small-cap version of the medical equipment index as an appropriate industry sector index because it considers that index to be representative of its size and the industry sector in which it operates. Entity W obtains the historical daily closing total return values of the selected index for the five years immediately prior to January 1, 20X6, from the Dow Jones Indexes website. It calculates the annualized historical volatility of those values to be 24 percent, based on 252 trading days per year.

A140. Entity W uses the inputs that it has determined above in a Black-Scholes-Merton option-pricing formula, which produces a value of $2.05 per share option. This results in total compensation cost of $20,500 (10,000 × $2.05) to be accounted for over the requisite service period of 3 years.

A141. For each of the 3 years ending December 31, 20X6, 20X7, and 20X8, Entity W will recognize compensation cost of $6,833 ($20,500 ÷ 3). The journal entry for each year is as follows:

Compensation cost	$6,833	
Additional paid-in capital		$6,833
To recognize compensation cost.		

Table 7—Share Option Award Granted by a Nonpublic Entity That Uses the Calculated Value Method

Year	Total Calculated Value of Award	Pretax Cost for Year	Cumulative Pretax Cost
20X6	$20,500 (10,000 × $2.05)	$6,833 ($20,500 ÷ 3)	$6,833
20X7	$20,500 (10,000 × $2.05)	$6,834 ($20,500 × ⅔ – $6,833)	$13,667
20X8	$20,500 (10,000 × $2.05)	$6,833 ($20,500 – $13,667)	$20,500

A142. Assuming that all 10,000 share options are exercised on the same day in 20Y2, the accounting for the option exercise will follow the same pattern as in Illustration 4 (paragraph A93) and will result in the following journal entry.

At exercise:

Cash (10,000 × $7)	$70,000	
Additional paid-in capital	$20,500	
Common stock		$90,500

To recognize the issuance of shares upon exercise of options and to reclassify previously recognized paid-in capital.

Illustration 11(c)—Share-Based Liability Award Granted by a Nonpublic Entity That Elects the Intrinsic Value Method

A143. On January 1, 20X6, Entity W, a nonpublic entity that has chosen the accounting policy of using the intrinsic value method of accounting for share-based payments that are classified as liabilities in accordance with paragraph 38 of this Statement, grants 100 cash-settled SARs with a 5-year life to each of its 100 employees. Each SAR entitles the holder to receive an amount in cash equal to the increase in value of 1 share of Entity W stock over $7. The awards cliff-vest at the end of three years of service (an explicit and requisite service period of three years). For simplicity, the example assumes that no forfeitures occur during the vesting period and does not reflect the accounting for income tax consequences of the awards.

A144. Because of Entity W's accounting policy decision to use intrinsic value, all of its share-based payments that are classified as liabilities are recognized at intrinsic value (or a portion thereof, depending on the percentage of requisite service that has been rendered) at each reporting date through the date of settlement; consequently, the compensation cost recognized in each year of the three-year requisite service period will vary based on changes in the liability award's intrinsic value. At December 31, 20X6, Entity W stock is valued at $10 per share; hence, the intrinsic value is $3 per SAR ($10 – $7), and the intrinsic value of the award is $30,000 (10,000 × $3). The compensation cost to be recognized for 20X6, is $10,000 ($30,000 ÷ 3), which corresponds to the service provided in 20X6 (1 year of the 3-year service period). For convenience, this example assumes that journal entries to account for the award are performed at year-end. The journal entry for 20X6 is as follows:

Compensation cost	$10,000	
Share-based compensation liability		$10,000

To recognize compensation cost.

A145. At December 31, 20X7, Entity W stock is valued at $8 per share; hence, the intrinsic value is $1 per SAR ($8 – $7), and the intrinsic value of the award is $10,000 (10,000 × $1). The decrease in the intrinsic value of the award is $20,000 ($10,000 – $30,000). Because services for 2 years of the 3-year service period have been rendered, Entity W must recognize cumulative compensation cost for two-thirds of the intrinsic value of the award, or $6,667 ($10,000 × ⅔); however, Entity W recognized compensation cost of $10,000 in 20X5. Thus, Entity W must recognize an entry in 20X7 to reduce cumulative compensation cost to $6,667:

Share-based compensation liability	$3,333	
Compensation cost		$3,333

To adjust cumulative compensation cost ($6,667 – $10,000).

A146. At December 31, 20X8, Entity W stock is valued at $15 per share; hence, the intrinsic value is $8 per SAR ($15 – $7), and the intrinsic value of the award is $80,000 (10,000 × $8). The cumulative compensation cost recognized at December 31, 20X8, is $80,000 because the award is fully vested. The journal entry for 20X8 is as follows:

Compensation cost	$73,333	
Share-based compensation liability		$73,333

To recognize compensation cost ($80,000 – $6,667).

Table 8—Share-Based Liability Award at Intrinsic Value

Year	Total Value of Award at Year-End	Pretax Cost for Year	Cumulative Pretax Cost
20X6	$30,000 (10,000 × $3)	$10,000 ($30,000 ÷ 3)	$10,000
20X7	$10,000 (10,000 × $1)	$(3,333) [($10,000 × ⅔) – $10,000)]	$6,667
20X8	$80,000 (10,000 × $8)	$73,333 ($80,000 – $6,667)	$80,000

A147. For simplicity, the illustration assumes that all of the SARs are settled on the day that they vest, December 31, 20X8, when the share price is $15 and the intrinsic value is $8 per share. The cash paid to settle the SARs is equal to the share-based compensation liability of $80,000.

At exercise:

Share-based compensation liability	$80,000	
Cash (10,000 × $8)		$80,000

To recognize the cash payment to employees for settlement of SARs.

A148. If the SARs had not been settled, Entity W would continue to remeasure those remaining awards at intrinsic value at each reporting date through the date they are exercised or otherwise settled.

Illustration 12—Modifications and Settlements

Illustration 12(a)—Modification of Vested Share Options

A149. The following examples of accounting for modifications of the terms of an award are based on Illustration 4(a) (paragraphs A86–A88), in which Entity T granted its employees 900,000 share options with an exercise price of $30 on January 1, 20X5. At January 1, 20X9, after the share options have vested, the market price of Entity T stock has declined to $20 per share, and Entity T decides to reduce the exercise price of the outstanding share options to $20. In effect, Entity T issues new share options with an exercise price of $20 and a contractual term equal to the remaining contractual term of the original January 1, 20X5, share options, which is 6 years, in exchange for the original vested share options. Entity T incurs additional compensation cost for the excess of the fair value of the modified share options issued over the fair value of the original share options at the date of the exchange, measured as shown in paragraph A150.[103] The modified share options are immediately vested, and the additional compensation cost is recognized in the period the modification occurs.

A150. The January 1, 20X9, fair value of the modified award is $7.14. To determine the amount of additional compensation cost arising from the modification, the fair value of the original vested share options assumed to be repurchased is computed immediately prior to the modification. The resulting fair value at January 1, 20X9, of the original share options is $3.67 per share option, based on their remaining contractual term of 6 years, suboptimal exercise factor of 2, $20 current share price, $30 exercise price, risk-free interest rates of 1.5 percent to 3.4 percent, expected volatility of 35 percent to 50 percent and a 1.0 percent expected dividend yield. The additional

[103]A nonpublic entity using the calculated value would compare the calculated value of the original award immediately before the modification with the calculated value of the modified award unless an entity has ceased to use the calculated value, in which case it would follow the guidance in paragraphs 51(a) and 51(b) of this Statement (calculating the effect of the modification based on the fair value).

compensation cost stemming from the modification is $3.47 per share option, determined as follows:

Fair value of modified share option at January 1, 20X9	$7.14
Less: Fair value of original share option at January 1, 20X9	3.67
Additional compensation cost to be recognized	$3.47

Compensation cost already recognized during the vesting period of the original award is $10,981,157 for 747,526 vested share options (refer to Illustration 4, paragraph A92). For simplicity, it is assumed that no share options were exercised before the modification. Previously recognized compensation cost is not adjusted. Additional compensation cost of $2,593,915 (747,526 vested share options × $3.47) is recognized on January 1, 20X9, because the modified share options are fully vested; any income tax effects from the additional compensation cost are recognized accordingly.

Illustration 12(b)—Share Settlement of Vested Share Options

A151. Rather than modify the option terms, Entity T offers to settle the original January 1, 20X5, share options for fully vested equity shares at January 1, 20X9. The fair value of each share option is estimated the same way as shown in Illustration 12(a) (refer to paragraphs A149 and A150), resulting in a fair value of $3.67 per share option. Entity T recognizes the settlement as the repurchase of an outstanding equity instrument, and no additional compensation cost is recognized at the date of settlement unless the payment in fully vested equity shares exceeds $3.67 per share option. Previously recognized compensation cost for the fair value of the original share options is not adjusted.

Illustration 12(c)—Modification of Nonvested Share Options

A152. This example assumes that Entity T granted its employees 900,000 share options with an exercise price of $30. At January 1, 20X6, 1 year into the 3-year vesting period, the market price of Entity T stock has declined to $20 per share, and Entity T decides to reduce the exercise price of the share options to $20. The 3-year cliff-vesting requirement is not changed. In effect, in exchange for the original nonvested share options, Entity T grants new share options with an exercise price of $20 and a contractual term equal to the 9-year remaining contractual term of the original share options granted on January 1, 20X5. Entity T incurs additional compensation cost for the excess of the fair value of the modified share options issued over the fair value of the original share options at the date of the exchange determined in the manner described in paragraph A150. Entity T adds that additional compensation cost to the

remaining unrecognized compensation cost for the original share options at the date of modification and recognizes the total amount ratably over the remaining two years of the three-year vesting period.[104]

A153. The January 1, 20X6 fair value of the modified award is $8.59 per share option, based on its contractual term of 9 years, suboptimal exercise factor of 2, $20 current share price, $20 exercise price, risk-free interest rates of 1.5 percent to 4.0 percent, expected volatilities of 35 percent to 55 percent, and a 1.0 percent expected dividend yield. The fair value of the original award immediately prior to the modification is $5.36 per share option, based on its remaining contractual term of 9 years, suboptimal exercise factor of 2, $20 current share price, $30 exercise price, risk-free interest rates of 1.5 percent to 4.0 percent, expected volatilities of 35 percent to 55 percent, and a 1.0 percent expected dividend yield. Thus, the additional compensation cost stemming from the modification is $3.23 per share option, determined as follows:

Fair value of modified share option at January 1, 20X6	$8.59
Less: Fair value of original share option at January 1, 20X6	5.36
Incremental value of modified share option at January 1, 20X6	$3.23

A154. On January 1, 20X6, the remaining balance of unrecognized compensation cost for the original share options is $9.79 per share option.[105] The total compensation cost for each modified share option that is expected to vest is $13.02, determined as follows:

Incremental value of modified share option	$ 3.23
Unrecognized compensation cost for original share option	9.79
Total compensation cost to be recognized	$13.02

That amount is recognized during 20X6 and 20X7, the two remaining years of the requisite service period.

Illustration 12(d)—Cash Settlement of Nonvested Share Options

A155. Rather than modify the share option terms, Entity T offers on January 1, 20X6, to settle the original January 1, 20X5, grant of share options for cash. Because the share price decreased from $30 at the grant date to $20 at the date of settlement, the fair value

[104]Because the original vesting provision is not changed, the modification has an explicit service period of two years, which represents the requisite service period as well. Thus, incremental compensation cost resulting from the modification would be recognized ratably over the remaining two years rather than in some other pattern.

[105]Using a value of $14.69 for the original option as noted in Illustration 4 (refer to paragraph A88) results in recognition of $4.90 ($14.69 ÷ 3) per year. The unrecognized balance at January 1, 20X6, is $9.79 ($14.69 – $4.90) per option.

of each share option is $5.36, the same as in Illustration 12(c) (refer to paragraphs A152–A154). If Entity T pays $5.36 per share option, it would recognize that cash settlement as the repurchase of an outstanding equity instrument and no incremental compensation cost would be recognized. However, the cash settlement of the share options effectively vests them. Therefore, the remaining unrecognized compensation cost of $9.79 per share option would be recognized at the date of settlement.

Illustration 12(e)—Equity Restructurings

A156. In accordance with paragraph 54 of this Statement, accounting for a modification in conjunction with an equity restructuring requires a comparison of the fair value of the modified award with the fair value of the original award immediately before the modification, except as follows: If an award is modified to add an antidilution provision (that is, a provision designed to equalize an award's value before and after an equity restructuring) and that modification is not made in contemplation of an equity restructuring, a comparison of the fair value of the modified award and the fair value of the original award immediately before the modification is not required. Paragraphs A157–A159 provide additional guidance on accounting for modifications of awards in the context of equity restructurings.

Original Award Contains Antidilution Provisions

A157. For example, assume an award contains antidilution provisions. On May 1 there is an announcement of a future equity restructuring. On October 12 the equity restructuring occurs and the terms of the award are modified in accordance with the antidilution provisions. In this example, the modification occurs on October 12 when the terms of the award are changed. The fair value of the award is compared pre- and post-modification on October 12. The calculation of fair value is necessary to determine if there is any incremental value transferred as a result of the modification, and if so, that incremental value would be recognized as additional compensation cost. If there is no incremental fair value, no additional compensation cost would be recognized.

Original Award* Does Not *Contain Antidilution Provisions

A158. In this example, the original award does not contain antidilution provisions. On May 1 there is an announcement of a future equity restructuring. On July 26 the terms of an award are modified to add antidilution provisions in contemplation of an equity restructuring. On September 30 the equity restructuring occurs. In this example, there are two modifications to account for. The first modification occurs on July 26, when the terms of the award are changed to add antidilution provisions. Because the modification to add antidilution provisions on July 26 is done in contemplation of an equity

restructuring, there must be a comparison of the fair value of the award pre- and post-modification on July 26. The pre-modification fair value is based on the award without antidilution provisions taking into account the effect of the contemplated restructuring on its value. The post-modification fair value is based on an award with antidilution provisions, taking into account the effect of the contemplated restructuring on its value. Any incremental value transferred would be recognized as additional compensation cost. Once the equity restructuring occurs, there is a second modification event on September 30 when the terms of the award are changed in accordance with the antidilution provisions. A second comparison of pre- and post-modification fair values is then required to determine whether any incremental value is transferred as a result of the modification. Changes to the terms of an award in accordance with its antidilution provisions generally would not result in additional compensation cost if the antidilution provisions were properly structured. The incremental value transferred, if any, would be recognized as additional compensation cost.

A159. Assume the same facts as in paragraph A158 except the terms of the awards are modified on the date of the equity restructuring, September 30. In contrast to paragraph A158 in which there are two separate modifications, there is one modification that occurs on September 30 and the fair value is compared pre- and post-modification to determine whether any incremental value is transferred as a result of the modification. Any incremental value transferred would be recognized as additional compensation cost.

Illustration 13—Modifications of Awards with Performance and Service Vesting Conditions

A160. Paragraphs A49–A51 note that awards may vest based on service conditions, performance conditions, or a combination of the two.[106] A modification of vesting conditions is accounted for based on the principles in paragraph 51 of this Statement: total recognized compensation cost for an equity award that is modified shall at least equal the fair value of the award at the grant date unless, at the date of the modification, the performance or service conditions of the original award are not expected to be satisfied. If awards are expected to vest under the original vesting conditions at the date of the modification, an entity should recognize compensation cost if either (a) the awards ultimately vest under the modified vesting conditions or (b) the awards ultimately would have vested under the original vesting conditions. In contrast, if at the date of modification awards are not expected to vest under the original vesting conditions, an entity should recognize compensation cost only if the awards vest under

[106]Modifications of market conditions that affect exercisability or the ability to retain the award are not addressed by this illustration.

the modified vesting conditions. Said differently, if the entity believes that the original performance or service vesting condition is not probable of achievement at the date of the modification, the cumulative compensation cost related to the modified award, assuming vesting occurs under the modified performance or service vesting condition, is the modified award's fair value at the date of the modification. The following examples (paragraphs A161–A170) illustrate the application of those requirements.

A161. Illustrations 13(a)–13(d) are all based on the same scenario: Entity T grants 1,000 share options to each of 10 employees in the sales department. The share options have the same terms and conditions as those described in Illustration 4 (paragraphs A86–A87), except that the share options specify that vesting is conditional upon selling 150,000 units of product A (the original sales target) over the 3-year explicit service period. The grant-date fair value of each option is $14.69 (refer to Illustration 4(a), paragraph A88). For simplicity, this example assumes that no forfeitures will occur from employee termination; forfeitures will only occur if the sales target is not achieved. Illustration 13(e) is not based on the same scenario as Illustrations 13(a)–13(d) but, rather, provides an additional illustration of a Type III modification.

Illustration 13(a)—Type I (Probable-to-Probable) Modification

A162. Based on historical sales patterns and expectations related to the future, management of Entity T believes at the grant date that it is probable that the sales target will be achieved. At January 1, 20X7, 102,000 units of product A have been sold. During December 20X6, one of Entity T's competitors declared bankruptcy after a fire destroyed a factory and warehouse containing the competitor's inventory. To push the sales people to take advantage of that situation, the award is modified on January 1, 20X7, to raise the sales target to 154,000 units of product A (the modified sales target).[107] Additionally, as of January 1, 20X7, the options are out-of-the-money because of a general stock market decline.[108] No other terms or conditions of the original award are modified, and management of Entity T continues to believe that it is probable that the modified sales target will be achieved. Immediately prior to the modification, total compensation cost expected to be recognized over the 3-year vesting period is $146,900 or $14.69 multiplied by the number of share options expected to vest (10,000). Because no other terms or conditions of the award were modified, the modification does not affect the per-share-option fair value (assumed to be $8 in this

[107]Notwithstanding the nature of the modification's probability of occurrence, the objective of this illustration is to demonstrate the accounting for a Type I modification.

[108]The examples in Illustration 13 assume that the options are out-of-the-money when modified; however, that fact is not determinative in the illustrations (that is, options could be in- or out-of-the-money).

example at the date of the modification). Moreover, because the modification does not affect the number of share options expected to vest, no incremental compensation cost is associated with the modification.

A163. This paragraph illustrates the cumulative compensation cost Entity T should recognize for the modified award based on three potential outcomes: Outcome 1—achievement of the modified sales target, Outcome 2—achievement of the original sales target, and Outcome 3—failure to achieve either sales target. In Outcome 1, all 10,000 share options vest because the salespeople sold at least 154,000 units of product A. In that outcome, Entity T will recognize cumulative compensation cost of $146,900. In Outcome 2, no share options vest because the salespeople sold more than 150,000 units of product A but less than 154,000 units (the modified sales target is not achieved). In that outcome, Entity T will recognize cumulative compensation cost of $146,900 because the share options would have vested under the original terms and conditions of the award. In Outcome 3, no share options vest because the modified sales target is not achieved; additionally, no share options would have vested under the original terms and conditions of the award. In that case, Entity T will recognize cumulative compensation cost of $0.

Illustration 13(b)—Type II (Probable-to-Improbable) Modification

A164. It is generally believed that Type II modifications will be rare; therefore, this illustration has been provided for the sake of completeness. Based on historical sales patterns and expectations related to the future, management of Entity T believes that at the grant date, it is probable that the sales target (150,000 units of product A) will be achieved. At January 1, 20X7, 102,000 units of product A have been sold and the options are out-of-the-money because of a general stock market decline. Entity T's management implements a cash bonus program based on achieving an annual sales target for 20X7.[109] Concurrently, the sales target for the option awards is revised to 170,000 units of product A. No other terms or conditions of the original award are modified. Management believes that the modified sales target is not probable of achievement; however, they continue to believe that the original sales target is probable of achievement. Immediately prior to the modification, total compensation cost expected to be recognized over the 3-year vesting period is $146,900 or $14.69 multiplied by the number of share options expected to vest (10,000). Because no other terms or conditions of the award were modified, the modification does not affect the per-share-option fair value (assumed in this example to be $8 at the modification date). Moreover, because the modification does not affect the number of share options

[109]The options are neither cancelled nor settled as a result of the cash bonus program. The cash bonus program would be accounted for using the same accounting as for other cash bonus arrangements.

expected to vest under the original vesting provisions, Entity T will determine incremental compensation cost in the following manner:

Fair value of modified share option	$ 8
Share options expected to vest under original sales target[110]	10,000
Fair value of modified award	$80,000
Fair value of original share option	$ 8
Share options expected to vest under original sales target	10,000
Fair value of original award	$80,000
Incremental compensation cost of modification	$ 0

A165. This paragraph illustrates the cumulative compensation cost Entity T should recognize for the modified award based on three potential outcomes: Outcome 1—achievement of the modified sales target, Outcome 2—achievement of the original sales target, and Outcome 3—failure to achieve either sales target. In Outcome 1, all 10,000 share options vest because the salespeople sold at least 170,000 units of product A. In that outcome, Entity T will recognize cumulative compensation cost of $146,900. In Outcome 2, no share options vest because the salespeople sold more than 150,000 units of product A but less than 170,000 units (the modified sales target is not achieved). In that outcome, Entity T will recognize cumulative compensation cost of $146,900 because the share options would have vested under the original terms and conditions of the award. In Outcome 3, no share options vest because the modified sales target is not achieved; additionally, no share options would have vested under the original terms and conditions of the award. In that case, Entity T will recognize cumulative compensation cost of $0.

Illustration 13(c)—Type III (Improbable-to-Probable) Modification

A166. Based on historical sales patterns and expectations related to the future, management of Entity T believes at the grant date that none of the options will vest because it is not probable that the sales target will be achieved. At January 1, 20X7, 80,000 units of product A have been sold. To further motivate the salespeople, the sales target (150,000 units of product A) is lowered to 120,000 units of product A (the modified sales target). No other terms or conditions of the original award are modified. Management believes that the modified sales target is probable of achievement. Immediately prior to the modification, total compensation cost expected to be

[110]In determining the fair value of the modified award for this type of modification, an entity should use the greater of the options expected to vest under the modified vesting condition or the options that previously had been expected to vest under the original vesting condition.

recognized over the 3-year vesting period is $0 or $14.69 multiplied by the number of share options expected to vest (zero). Because no other terms or conditions of the award were modified, the modification does not affect the per-share-option fair value (assumed in this example to be $8 at the modification date). Since the modification affects the number of share options expected to vest under the original vesting provisions, Entity T will determine incremental compensation cost in the following manner:

Fair value of modified share option	$ 8
Share options expected to vest under modified sales target	10,000
Fair value of modified award	$80,000
Fair value of original share option	$ 8
Share options expected to vest under original sales target	0
Fair value of original award	$ 0
Incremental compensation cost of modification	$80,000

A167. This paragraph illustrates the cumulative compensation cost Entity T should recognize for the modified award based on three potential outcomes: Outcome 1—achievement of the modified sales target, Outcome 2—achievement of the original sales target and the modified sales target, and Outcome 3—failure to achieve either sales target. In Outcome 1, all 10,000 share options vest because the salespeople sold at least 120,000 units of product A. In that outcome, Entity T will recognize cumulative compensation cost of $80,000. In Outcome 2, Entity T will recognize cumulative compensation cost of $80,000 because in a Type III modification the original vesting condition is generally not relevant (that is, the modified award generally vests at a lower threshold of service or performance). In Outcome 3, no share options vest because the modified sales target is not achieved; in that case, Entity T will recognize cumulative compensation cost of $0.

Illustration 13(d)—Type IV (Improbable-to-Improbable) Modification

A168. Based on historical sales patterns and expectations related to the future, management of Entity T believes that at the grant date it is not probable that the sales target will be achieved. At January 1, 20X7, 80,000 units of product A have been sold. To further motivate the salespeople, the sales target is lowered to 130,000 units of product A (the modified sales target). No other terms or conditions of the original award are modified. Entity T lost a major customer for product A in December 20X6; hence, management continues to believe that the modified sales target is not probable of achievement. Immediately prior to the modification, total compensation cost expected to be recognized over the 3-year vesting period is $0 or $14.69 multiplied by the number of share options expected to vest (zero). Because no other terms or conditions

of the award were modified, the modification does not affect the per-share-option fair value (assumed in this example to be $8 at the modification date). Furthermore, the modification does not affect the number of share options expected to vest; hence, there is no incremental compensation cost associated with the modification.

A169. This paragraph illustrates the cumulative compensation cost Entity T should recognize for the modified award based on three potential outcomes: Outcome 1—achievement of the modified sales target, Outcome 2—achievement of the original sales target and the modified sales target, and Outcome 3—failure to achieve either sales target. In Outcome 1, all 10,000 share options vest because the salespeople sold at least 130,000 units of product A. In that outcome, Entity T will recognize cumulative compensation cost of $80,000 (10,000 × $8). In Outcome 2, Entity T will recognize cumulative compensation cost of $80,000 because in a Type IV modification the original vesting condition is generally not relevant (that is, the *modified* award generally vests at a lower threshold of service or performance). In Outcome 3, no share options vest because the modified sales target is not achieved; in that case, Entity T will recognize cumulative compensation cost of $0.

Illustration 13(e)—An Additional Illustration of a Type III (Improbable-to-Probable) Modification

A170. On January 1, 20X7, Entity Z issues 1,000 at-the-money options with a 4-year explicit service condition to each of 50 employees that work in Plant J. On December 12, 20X7, Entity Z decides to close Plant J and notifies the 50 Plant J employees that their employment relationship will be terminated effective June 30, 20X8. On June 30, 20X8, Entity Z accelerates vesting of all options. The grant date fair value of each option is $20 on January 1, 20X7, and $10 on June 30, 20X8, the modification date. At the date of modification, the service condition of the original award is not expected to be satisfied because the employees cannot render the requisite service; therefore, any compensation cost recognized as of the modification date for the original award would be reversed at the modification date. However, the modified award is fully vested as a result of the vesting acceleration. Therefore, at the date of the modification, the fair value of the original award, which is $0 ($10 × 0 options expected to vest under the original terms of the award), is subtracted from the fair value of the modified award $500,000 ($10 × 50,000 options expected to vest under the modified award). The total recognized compensation cost of $500,000 will be less than the fair value of the award at the grant date ($1 million) because at the date of the modification, the original vesting conditions were not expected to be satisfied.

Illustration 14—Modifications That Change an Award's Classification

A171. A modification may affect the classification of an award (for example, change the award from an equity instrument to a liability instrument). If an entity modifies an award in that manner, this Statement requires that the entity account for that modification in accordance with paragraph 51 of this Statement.

Illustration 14(a)—Equity-to-Liability Modification (Share-Settled Share Options to Cash-Settled Share Options)

A172. Entity T grants the same share options described in Illustration 4(a) (paragraphs A86–A90). The number of options for which the requisite service is expected to be rendered is estimated at the grant date to be 821,406 (900,000 × $.97^3$). For simplicity, this example assumes that estimated forfeitures equal actual forfeitures. Thus, as shown in Table 9 (paragraph A177), the fair value of the award at January 1, 20X5, is $12,066,454 (821,406 × $14.69), and the compensation cost to be recognized during each year of the 3-year vesting period is $4,022,151 ($12,066,454 ÷ 3). The journal entries for 20X5 are the same as those in paragraph A91.

A173. On January 1, 20X6, Entity T modifies the share options granted to allow the employee the choice of share settlement or net-cash settlement; the options no longer qualify as equity because the holder can require Entity T to settle the options by delivering cash. Because the modification affects no other terms or conditions of the options, the fair value (assumed to be $7 per share option) of the modified award equals the fair value of the original award immediately before its terms are modified on the date of modification; the modification also does not change the number of share options for which the requisite service is expected to be rendered. On the modification date, Entity T recognizes a liability equal to the portion of the award attributed to past service multiplied by the modified award's fair value. To the extent that the liability equals or is less than the amount recognized in equity for the original award, the offsetting debit is a charge to equity. To the extent that the liability exceeds the amount recognized in equity for the original award, the excess is recognized as compensation cost. In this example, at the modification date, one-third of the award is attributed to past service (one year of service rendered ÷ three-year requisite service period). The modified

award's fair value is $5,749,842 (821,406 × $7), and the liability to be recognized at the modification date is $1,916,614 ($5,749,842 ÷ 3). The related journal entry follows.

Additional paid-in capital	$1,916,614	
Share-based compensation liability		$1,916,614
To recognize the share-based compensation liability.		

A174. No entry should be made to the deferred tax accounts at the modification date. The amount of remaining additional paid-in capital attributable to compensation cost recognized in 20X5 is $2,105,537 ($4,022,151 – $1,916,614).

A175. Paragraph 51(b) of this Statement specifies that total recognized compensation cost for an equity award shall at least equal the fair value of the award at the grant date unless at the date of the modification the service or performance conditions of the original award are not expected to be satisfied. In accordance with that principle, Entity T will ultimately recognize cumulative compensation cost equal to the greater of (a) the grant-date fair value of the original equity award and (b) the fair value of the modified liability award when it is settled. To the extent that the recognized fair value of the modified liability award is less than the recognized compensation cost associated with the grant-date fair value of the original equity award, changes in that liability award's fair value through its settlement do not affect the amount of compensation cost recognized. To the extent that the fair value of the modified liability award exceeds the recognized compensation cost associated with the grant-date fair value of the original equity award, changes in the liability award's fair value are recognized as compensation cost.

A176. At December 31, 20X6, the fair value of the modified award is assumed to be $25 per share option; hence, the modified award's fair value is $20,535,150 (821,406 × $25), and the corresponding liability at that date is $13,690,100 ($20,535,150 × ⅔) because two-thirds of the requisite service period has been rendered. The increase in the fair value of the liability award is $11,773,486 ($13,690,100 – $1,916,614). Prior to any adjustments for 20X6, the amount of remaining additional paid-in capital attributable to compensation cost recognized in 20X5 is $2,105,537 ($4,022,151 – $1,916,614). The

cumulative compensation cost at December 31, 20X6, associated with the grant-date fair value of the original equity award is $8,044,302 ($4,022,151 × 2). Entity T records the following journal entries for 20X6:

Compensation cost	$9,667,949	
Additional paid-in capital	$2,105,537	
Share-based compensation liability		$11,773,486

To increase the share-based compensation liability to $13,690,100 and recognize compensation cost of $9,667,949 ($13,690,100 – $4,022,151).

Deferred tax asset	$3,383,782	
Deferred tax benefit		$3,383,782

To recognize the deferred tax asset for additional compensation cost ($9,667,949 × .35 = $3,383,782).

A177. At December 31, 20X7, the fair value is assumed to be $10 per share option; hence, the modified award's fair value is $8,214,060 (821,406 × $10), and the corresponding liability for the fully vested award at that date is $8,214,060. The decrease in the fair value of the liability award is $5,476,040 ($8,214,060 – $13,690,100). The cumulative compensation cost as of December 31, 20X7, associated with the grant-date fair value of the original equity award is $12,066,454 (paragraph A172). Entity T records the following journal entries for 20X7:

Share-based compensation liability	$5,476,040	
Compensation cost		$1,623,646
Additional paid-in capital		$3,852,394

To recognize a share-based compensation liability of $8,214,060, a reduction of compensation cost of $1,623,646 ($13,690,100 – $12,066,454), and additional paid-in capital of $3,852,394 ($12,066,454 – $8,214,060).

Deferred tax expense	$568,276	
Deferred tax asset		$568,276

To reduce the deferred tax asset for the reduction in compensation cost ($1,623,646 × .35 = $568,276).

Table 9—Modified Liability Award—Cliff Vesting

Year	Total Value of Award	Pretax Cost for Year	Cumulative Pretax Cost
20X5	$12,066,454 (821,406 × $14.69)	$4,022,151 ($12,066,454 ÷ 3)	$4,022,151
20X6	$20,535,150 (821,406 × $25.00)	$9,667,949 [($20,535,150 × ⅔) – $4,022,151]	$13,690,100
20X7	$12,066,454 (821,406 × $14.69)	$(1,623,646) ($12,066,454 – $13,690,100)	$12,066,454

Income Taxes

A178. For simplicity, this illustration assumes that all share option holders elected to be paid in cash on the same day, that the liability award's fair value is $10 per option, and that Entity T has already recognized its income tax expense for the year without regard to the effects of the settlement of the award. In other words, current tax expense and current taxes payable were recognized based on income and deductions before consideration of additional deductions from settlement of the award.

A179. The $8,214,060 in cash paid to the employees on the date of settlement is deductible for tax purposes. In the period of settlement, tax return deductions that are less than compensation cost recognized result in a charge to income tax expense except to the extent that there is any remaining additional paid-in capital from excess tax benefits from previous share-based payment awards available to offset that deficiency. The entity has sufficient taxable income, and the tax benefit realized is $2,874,921 ($8,214,060 × .35). As tax return deductions are less than compensation cost recognized, the entity must write off the deferred tax assets recognized in excess of the tax benefit ultimately realized from the exercise of employee stock options. Entity T has sufficient paid-in capital available from excess tax benefits from previous share-based payment awards to offset the entire tax deficiency. Therefore, the result is a debit to additional paid-in capital. The journal entries to reflect settlement of the share options are as follows:

Share-based compensation liability	$8,214,060	
Cash ($10 × 821,406)		$8,214,060

To recognize the cash paid to settle share options.

Deferred tax expense	$4,223,259	
Deferred tax asset		$4,223,259

To write off deferred tax asset related to compensation cost ($12,066,454 × .35 = $4,223,259).

Current taxes payable	$2,874,921	
Additional paid-in capital	$1,348,338	
Current tax expense		$4,223,259

To adjust current tax expense and current taxes payable for the tax benefit from deductible compensation cost upon settlement of share options.

A180. If instead of requesting cash, employees had held their share options and those options had expired worthless, the share-based compensation liability account would have been eliminated over time with a corresponding increase to additional paid-in capital. Previously recognized compensation cost would not be reversed. Similar to the adjustment for the actual tax deduction realized described in paragraph A179, all of the deferred tax asset of $4,223,259 would be charged to income tax expense except to the extent that there was any remaining paid-in capital available from excess tax benefits from previous share-based payment awards available to offset that deficiency when the share options expired.

Illustration 14(b)—Equity-to-Equity Modification (Share Options to Shares)

A181. Equity-to-equity modifications also are addressed in Illustrations 12 and 13. The following example is based on Illustration 4(a) (paragraphs A86–A96), in which Entity T granted its employees 900,000 options with an exercise price of $30 on January 1, 20X5. At January 1, 20X9, after 747,526 share options have vested, the market price of Entity T stock has declined to $8 per share, and Entity T offers to exchange 4 options with an assumed per-share-option fair value of $2 at the date of exchange for 1 share of nonvested stock, with a market price of $8 per share. The nonvested stock will cliff vest after two years of service. All option holders elect to participate, and at the date of exchange, Entity T grants 186,881 (747,526 ÷ 4) nonvested shares of stock. Because the fair value of the nonvested stock is equal to the fair value of the options, there is no incremental compensation cost. Entity T will not make any additional accounting entries for the shares regardless of whether they vest, other than possibly reclassifying amounts in equity; however, Entity T will need to account for the ultimate income tax effects related to the share-based compensation arrangement.

Illustration 14(c)—Liability-to-Equity Modification (Cash-Settled to Share-Settled SARs)

A182. This illustration is based on the facts given in Illustration 10 (paragraphs A127–A133): Entity T grants cash-settled SARs to its employees. The fair value of the award at January 1, 20X5, is $12,066,454 (821,406 × $14.69) (paragraph A127).

A183. At December 31, 20X5, the assumed fair value is $10 per SAR; hence, the fair value of the award at that date is $8,214,060 (821,406 × $10). The share-based compensation liability at December 31, 20X5, is $2,738,020 ($8,214,060 ÷ 3), which reflects the portion of the award related to the requisite service provided in 20X5 (1 year of the 3-year requisite service period). For convenience, this example assumes that journal entries to account for the award are performed at year-end. The journal entries for 20X5 are as follows:

Compensation cost	$2,738,020	
Share-based compensation liability		$2,738,020
To recognize compensation cost.		

Deferred tax asset	$958,307	
Deferred tax benefit		$958,307

To recognize the deferred tax asset for the temporary difference related to compensation cost ($2,738,020 × .35 = $958,307).

A184. On January 1, 20X6, Entity T modifies the SARs by replacing the cash-settlement feature with a net-share settlement feature, which converts the award from a liability award to an equity award because Entity T no longer has an obligation to transfer cash to settle the arrangement. Entity T would compare the fair value of the instrument immediately before the modification to the fair value of the modified award and recognize any incremental compensation cost. Because the modification affects no other terms or conditions, the fair value, assumed to be $10 per SAR, is unchanged by the modification and, therefore, no incremental compensation cost is recognized. The modified award's total fair value is $8,214,060. The modified award would be accounted for as an equity award from the date of modification with a fair value of $10 per share. Therefore, at the modification date, the entity would reclassify the liability of $2,738,020 recognized at December 31, 20X5, as additional paid-in capital. The related journal entry is as follows:

Share-based compensation liability	$2,738,020	
Additional paid-in capital		$2,738,020
To reclassify the award as equity.		

Entity T will account for the modified awards as equity going forward following the pattern given in Illustration 4(a) (refer to paragraphs A86–A96), recognizing $2,738,020 of compensation cost in each of 20X6 and 20X7, for a cumulative total of $8,214,060.

Illustration 14(d)—Liability-to-Liability Modification (Cash-Settled SARs to Cash-Settled SARs)

A185. This illustration is based on the facts given in Illustration 10 (paragraphs A127–A133): Entity T grants SARs to its employees. The fair value of the award at January 1, 20X5, is $12,066,454 (821,406 × $14.69).

A186. At December 31, 20X5, the fair value of each SAR is assumed to be $5; hence, the fair value of the award is $4,107,030 (821,406 × $5). The share-based compensation liability at December 31, 20X5, is $1,369,010 ($4,107,030 ÷ 3), which reflects the portion of the award related to the requisite service provided in 20X5 (1 year of the 3-year requisite service period). For convenience, this example assumes that journal entries to account for the award are performed at year-end. The journal entries to recognize compensation cost for 20X5 are as follows:

Compensation cost	$1,369,010	
Share-based compensation liability		$1,369,010

To recognize compensation cost.

Deferred tax asset	$479,154	
Deferred tax benefit		$479,154

To recognize the deferred tax asset for the temporary difference related to compensation cost ($1,369,010 × .35 = $479,154).

A187. On January 1, 20X6, Entity T reprices the SARs, giving each holder the right to receive an amount in cash equal to the increase in value of 1 share of Entity T stock over $10. The modification affects no other terms or conditions of the SARs and does

not change the number of SARs expected to vest. The fair value of each SAR based on its modified terms is $12. The incremental compensation cost is calculated per the method in Illustration 12:

Fair value of modified SAR award (821,406 × $12)	$9,856,872
Less: Fair value of original SAR (821,406 × $5)	4,107,030
Incremental value of modified SAR	5,749,842
Divide by three to reflect earned portion of the award	÷ 3
Compensation cost to be recognized	$1,916,614

A188. Entity T also could determine the incremental value of the modified SAR award by multiplying the fair value of the modified SAR award by the portion of the award that is earned and subtracting the cumulative recognized compensation cost [($9,856,872 ÷ 3) – $1,369,010 = $1,916,614]. As a result, Entity T will record the following journal entries at the date of the modification:

Compensation cost	$1,916,614	
Share-based compensation liability		$1,916,614
To recognize incremental compensation cost.		

Deferred tax asset	$670,815	
Deferred tax benefit		$670,815

To recognize the deferred tax asset for the temporary difference related to additional compensation cost ($1,916,614 × .35 = $670,815).

Entity T will continue to remeasure the liability award at each reporting date until the award's settlement.

Illustration 14(e)—Equity-to-Liability Modification (Share Options to Fixed Cash Payment)

A189. Entity T grants the same share options described in Illustration 4(a) (paragraphs A86–A96) and records similar journal entries for 20X5 (paragraph A91). By January 1, 20X6, Entity T's share price has fallen, and the fair value per share option is assumed to be $2 at that date. Entity T provides its employees with an election to convert each share option into an award of a fixed amount of cash equal to the fair value of each share option on the election date ($2) accrued over the remaining requisite service period, payable upon vesting. The election does not affect vesting; that is, employees must satisfy the original service condition to vest in the award for a fixed amount of cash. This transaction is considered a modification because Entity T continues to have an obligation to its employees that is conditional upon the receipt of future employee services. There is no incremental compensation cost because the fair

value of the modified award is the same as that of the original award. At the date of the modification, a liability of $547,604 [(821,406 × $2) × (1 year of requisite service rendered ÷ 3-year requisite service period)], which is equal to the portion of the award attributed to past service multiplied by the modified award's fair value, is recognized by reclassifying that amount from additional paid-in capital. The total liability of $1,642,812 (821,406 × $2) should be fully accrued by the end of the requisite service period. Because the possible tax deduction of the modified award is capped at $1,642,812, Entity T also must adjust its deferred tax asset at the date of the modification to the amount that corresponds to the recognized liability of $547,604. That amount is $191,661 ($547,604 × .35), and the write-off of the deferred tax asset is $1,216,092 ($1,407,753 – $191,661). That write-off would be recognized in the income statement except to the extent that there is any remaining additional paid-in capital from excess tax benefits from previous share-based payment awards available to offset that deficiency. Compensation cost of $4,022,151 and a corresponding increase in additional paid-in capital would be recognized in each of 20X6 and 20X7 for a cumulative total of $12,066,454 (refer to Illustration 14(a)); however, that compensation cost has no associated income tax effect (additional deferred tax assets are recognized based only on subsequent increases in the amount of the liability).

Illustration 15—Share Award with a Clawback Feature

A190. On January 1, 20X5, Entity T grants its CEO an award of 100,000 shares of stock that vest upon the completion of 5 years of service. The market price of Entity T's stock is $30 per share on that date. The grant-date fair value of the award is $3,000,000 (100,000 × $30). The shares become freely transferable upon vesting; however, the award provisions specify that, in the event of the employee's termination and subsequent employment by a direct competitor (as defined by the award) within three years after vesting, the shares or their cash equivalent on the date of employment by the direct competitor must be returned to Entity T for no consideration (a clawback feature). The CEO completes five years of service and vests in the award. Approximately two years after vesting in the share award, the CEO terminates employment and is hired as an employee of a direct competitor. Paragraph A5 states that contingent features requiring an employee to transfer equity shares earned or realized gains from the sale of equity instruments earned as a result of share-based payment arrangements to the issuing entity for consideration that is less than fair value on the date of transfer (including no consideration) are not considered in estimating the fair value of an equity instrument on the date it is granted. Those features are accounted for if and when the contingent event occurs by recognizing the consideration received in the corresponding balance sheet account and a credit in the income statement equal to the lesser of the recognized compensation cost of the share-based payment arrangement that contains

the contingent feature ($3,000,000) and the fair value of the consideration received.[111] The former CEO returns 100,000 shares of Entity T's common stock with a total market value of $4,500,000 as a result of the award's provisions. The following journal entry accounts for that event:

Treasury stock	$4,500,000	
Additional paid-in capital		$1,500,000
Other income		$3,000,000

To recognize the receipt of consideration as a result of the clawback feature.

A191. If instead of delivering shares to Entity T, the former CEO had paid cash equal to the total market value of 100,000 shares of Entity T's common stock, the following journal entry would have been recorded:

Cash	$4,500,000	
Additional paid-in capital		$1,500,000
Other income		$3,000,000

To recognize the receipt of consideration as a result of the clawback feature.

Illustration 16—Certain Noncompete Agreements and Requisite Service

A192. Paragraph 6 of this Statement requires that the accounting for all share-based payment transactions with employees or others reflect the rights conveyed to the holder of the instruments and the obligations imposed on the issuer of the instruments, regardless of how those transactions are structured. Some share-based compensation arrangements with employees may contain noncompete provisions. Those noncompete provisions may be in-substance service conditions because of their nature. Determining whether a noncompete provision or another type of provision represents an in-substance service condition is a matter of judgment based on relevant facts and circumstances. The following example in paragraphs A193–A197 illustrates a situation in which a noncompete provision represents an in-substance service condition.

A193. Entity K is a professional services firm in which retention of qualified employees is important in sustaining its operations. Entity K's industry expertise and relationship networks are inextricably linked to its employees; if its employees terminate their employment relationship and work for a competitor, the company's operations may be adversely impacted.

[111]This guidance does not apply to cancellations of awards of equity instruments as discussed in paragraphs 55–57 of this Statement.

A194. As part of its compensation structure, Entity K grants 100,000 restricted share units (RSUs) to an employee on January 1, 20X6. The fair value of the RSUs represents approximately four times the expected future annual total compensation of the employee. The RSUs are fully vested as of the date of grant, and retention of the RSUs is not contingent on future service to Entity K. However, the units are transferred to the employee based on a 4-year delayed-transfer schedule (25,000 RSUs to be transferred beginning on December 31, 20X6, and on December 31 in each of the 3 succeeding years) if and only if specified noncompete conditions are satisfied. The RSUs are convertible into unrestricted shares any time after transfer.

A195. The noncompete provisions require that no work in any capacity may be performed for a competitor (which would include any new competitor formed by the employee). Those noncompete provisions lapse with respect to the RSUs as they are transferred. If the noncompete provisions are not satisfied, the employee loses all rights to any RSUs not yet transferred. Additionally, the noncompete provisions stipulate that Entity K may seek other available legal remedies, including damages from the employee. Entity K has determined that the noncompete is legally enforceable and has legally enforced similar arrangements in the past.

A196. The nature of the noncompete provision (being the corollary condition of active employment), the provision's legal enforceability, the employer's intent to enforce and past practice of enforcement, the delayed-transfer schedule mirroring the lapse of noncompete provisions, the magnitude of the award's fair value in relation to the employee's expected future annual total compensation, and the severity of the provision limiting the employee's ability to work in the industry in any capacity are facts that provide a preponderance of evidence suggesting that the arrangement is designed to compensate the employee for future service in spite of the employee's ability to terminate the employment relationship during the service period and retain the award (assuming satisfaction of the noncompete provision). Consequently, Entity K would recognize compensation cost related to the RSUs over the four-year substantive service period.

A197. Illustration 15 (paragraphs A190 and A191) provides an example of another noncompete agreement. Illustration 15 and this illustration are similar in that both noncompete agreements are not contingent upon employment termination (that is, both agreements may activate and lapse during a period of active employment subsequent to the vesting date). A key difference between the two illustrations is that the award recipient in Illustration 15 must provide five years of service to vest in the award (as opposed to vesting immediately). Another key difference is that the award recipient in Illustration 15 receives the shares upon vesting and may sell them immediately without

restriction as opposed to the RSUs, which are transferred according to the delayed-transfer schedule. In Illustration 15, the noncompete provision is not deemed to be an in-substance service condition.[112]

Illustration 17—Tandem Award—Share Options or Cash-Settled SARs

A198. A tandem award is an award with two (or more) components in which exercise of one part cancels the other(s). In contrast, a **combination award** is an award with two separate components, both of which can be exercised.

A199. The following illustrates the accounting for a tandem award in which employees have a choice of either share options or cash-settled SARs. Entity T grants to its employees an award of 900,000 share options or 900,000 cash-settled SARs on January 1, 20X5. The award vests on December 31, 20X7, and has a contractual life of 10 years. If an employee exercises the SARs, the related share options are cancelled. Conversely, if an employee exercises the share options, the related SARs are cancelled.

A200. The tandem award results in Entity T's incurring a liability because the employees can demand settlement in cash. If Entity T could choose whether to settle the award in cash or by issuing stock, the award would be an equity instrument unless Entity T's predominant past practice is to settle most awards in cash or to settle awards in cash whenever requested to do so by the employee, indicating that Entity T has incurred a substantive liability as indicated in paragraph 34 of this Statement. In this illustration, however, Entity T incurs a liability to pay cash, which it will recognize over the requisite service period. The amount of the liability will be adjusted each year to reflect changes in its fair value. If employees choose to exercise the share options rather than the SARs, the liability is settled by issuing stock.

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[112]In making a determination about whether a noncompete provision may represent an in-substance service condition, the provision's legal enforceability, the entity's intent to enforce the provision and its past practice of enforcement, the employee's rights to the instruments such as the right to sell them, the severity of the provision, the fair value of the award, and the existence or absence of an explicit employee service condition are all factors that should be considered. Because noncompete provisions can be structured differently, one or more of those factors (such as the entity's intent to enforce the provision) may be more important than others in making that determination. For example, if Entity K did not intend to enforce the provision, then the noncompete provision would not represent an in-substance service condition.

A201. The fair value of the SARs at the grant date is $12,066,454, as computed in Illustration 10 (paragraphs A127–A133), because the value of the SARs and the value of the share options are equal. Accordingly, at the end of 20X5, when the assumed fair value per SAR is $10, the amount of the liability is $8,214,060 (821,406 cash-settled SARs expected to vest × $10). One-third of that amount, $2,738,020, is recognized as compensation cost for 20X5. At the end of each year during the vesting period, the liability is remeasured to its fair value for all SARs expected to vest. After the vesting period, the liability for all outstanding vested awards is remeasured through the date of settlement.

Illustration 18—Tandem Award—Phantom Shares or Share Options

A202. This illustration is for a tandem award in which the components have different values after the grant date, depending on movements in the price of the entity's stock. The employee's choice of which component to exercise will depend on the relative values of the components when the award is exercised.

A203. Entity T grants to its CEO an immediately vested award consisting of two parts:

a. One thousand phantom share units (units) whose value is always equal to the value of 1,000 shares of Entity T's common stock
b. Share options on 3,000 shares of Entity T stock with an exercise price of $30 per share.

At the grant date, Entity T's share price is $30 per share. The CEO may choose whether to exercise the share options or to cash in the units at any time during the next five years. Exercise of all of the share options cancels all of the units, and cashing in all of the units cancels all of the share options. The cash value of the units will be paid to the CEO at the end of five years if the share option component of the tandem award is not exercised before then.

A204. With a 3-to-1 ratio of share options to units, exercise of 3 share options will produce a higher gain than receipt of cash equal to the value of 1 share of stock if the share price appreciates from the grant date by more than 50 percent. Below that point,

one unit is more valuable than the gain on three share options. To illustrate that relationship, the results if the share price increases 50 percent to $45 are:

	Units		Exercise of Options	
Market value	$45,000	($45 × 1,000)	$135,000	($45 × 3,000)
Purchase price	0		90,000	($30 × 3,000)
Net cash value	$45,000		$ 45,000	

A205. If the price of Entity T's common stock increases to $45 per share from its price of $30 at the grant date, each part of the tandem grant will produce the same net cash payment (ignoring transaction costs) to the CEO. If the price increases to $44, the value of 1 share of stock exceeds the gain on exercising 3 share options, which would be $42 [3 × ($44 – $30)]. But if the price increases to $46, the gain on exercising 3 share options, $48 [3 × ($46 – $30)], exceeds the value of 1 share of stock.

A206. At the grant date, the CEO could take $30,000 cash for the units and forfeit the share options. Therefore, the total value of the award at the grant date must exceed $30,000 because at share prices above $45, the CEO receives a higher amount than would the holder of 1 share of stock. To exercise the 3,000 options, the CEO must forfeit the equivalent of 1,000 shares of stock, in addition to paying the total exercise price of $90,000 (3,000 × $30). In effect, the CEO receives only 2,000 shares of Entity T stock upon exercise. That is the same as if the share option component of the tandem award consisted of share options to purchase 2,000 shares of stock for $45 per share.

A207. The cash payment obligation associated with the units qualifies the award as a liability of Entity T. The maximum amount of that liability, which is indexed to the price of Entity T's common stock, is $45,000 because at share prices above $45, the CEO will exercise the share options.

A208. In measuring compensation cost, the award may be thought of as a *combination*—not tandem—grant of (a) 1,000 units with a value at grant of $30,000 and (b) 2,000 options with a strike price of $45 per share. Compensation cost is measured based on the combined value of the two parts.

A209. The fair value per share option with an exercise price of $45 is assumed to be $10. Therefore, the total value of the award at the grant date is:

Units (1,000 × $30)	$30,000
Share options (2,000 × $10)	20,000
Value of award	$50,000

A210. Therefore, compensation cost recognized at the date of grant (the award is immediately vested) would be $30,000 with a corresponding credit to a share-based compensation liability of $30,000. However, because the share option component is the substantive equivalent of 2,000 deep out-of-the-money options, it contains a derived service period (assumed to be 2 years). Hence, compensation cost for the share option component of $20,000 would be recognized over the requisite service period.[113] That total amount of both components (or $50,000) is more than either of the components by itself, but less than the total amount if both components (1,000 units and 3,000 share options with an exercise price of $30) were exercisable. Because granting the units creates a liability, changes in the liability that result from increases or decreases in the price of Entity T's share price would be recognized each period until exercise, except that the amount of the liability would not exceed $45,000.

Illustration 19—Look-Back Share Options

A211. Some entities offer share options to employees under Section 423 of the U.S. Internal Revenue Code, which provides that employees will not be immediately taxed on the difference between the market price of the stock and a discounted purchase price if several requirements are met. One requirement is that the exercise price may not be less than the smaller of (a) 85 percent of the stock's market price when the share option is granted and (b) 85 percent of the price at exercise. A share option that provides the employee the choice of (a) or (b) may not have a term in excess of 27 months. Share options that provide for the more favorable of two (or more) exercise prices are referred to as look-back share options. A look-back share option with a 15 percent discount from the market price at either grant or exercise is worth more than a fixed share option to purchase stock at 85 percent of the current market price because the holder of the look-back share option is assured a benefit. If the price rises, the holder benefits to the same extent as if the exercise price was fixed at the grant date. If the share price falls, the holder still receives the benefit of purchasing the stock at a 15 percent discount from its price at the date of exercise. An employee share purchase plan offering share options with a look-back feature would be compensatory because the look-back feature is an option feature (paragraph 12).

A212. For example, on January 1, 20X5, when its share price is $30, Entity T offers its employees the opportunity to sign up for a payroll deduction to purchase its stock at either 85 percent of the share's current price or 85 percent of the price at the end of the year when the share options expire, whichever is lower. The exercise price of the share

[113]The share option component would not be remeasured because it is not a liability.

options is the lesser of (a) $25.50 ($30 × .85) and (b) 85 percent of the share price at the end of the year when the share options expire.

A213. The look-back share option can be valued as a combination position.[114] In this situation, the components are as follows:

a. 0.15 of a share of nonvested stock
b. 0.85 of a 1-year share option held with an exercise price of $30.

Supporting analysis for the two components is discussed below.

A214. Beginning with the first component, a share option with an exercise price that equals 85 percent of the value of the stock at the exercise date will always be worth 15 percent (100% – 85%) of the share price upon exercise. For a stock that pays no dividends, that share option is the equivalent of 15 percent of a share of the stock. The holder of the look-back share option will receive *at least* the equivalent of 0.15 of a share of stock upon exercise, regardless of the share price at that date. For example, if the share price falls to $20, the exercise price of the share option will be $17 ($20 × .85), and the holder will benefit by $3 ($20 – $17), which is the same as receiving 0.15 of a share of stock for each share option.

A215. If the share price upon exercise is more than $30, the holder of the look-back share option receives a benefit that is worth more than 15 percent of a share of stock. At prices of $30 or more, the holder receives a benefit for the difference between the share price upon exercise and $25.50—the exercise price of the share option (.85 × $30). If the share price is $40, the holder benefits by $14.50 ($40 – $25.50). However, the holder cannot receive *both* the $14.50 value of a share option with an exercise price of $25.50 *and* 0.15 of a share of stock. In effect, the holder gives up 0.15 of a share of stock worth $4.50 ($30 × .15) if the share price is above $30 at exercise. The result is the same as if the exercise price of the share option was $30 ($25.50 + $4.50) and the holder of the look-back share option held 85 percent of a 1-year share option with an exercise price of $30 in addition to 0.15 of a share of stock that will be received if the share price is $30 or less upon exercise.

[114]This illustration presents one of several existing valuation techniques for estimating the fair value of a look-back option. In accordance with this Statement, an entity should use a valuation technique that reflects the substantive characteristics of the instrument being granted in the estimate of fair value.

A216. An option-pricing model can be used to value the 1-year share option on 0.85 of a share of stock represented by the second component. Thus, assuming that the fair value of a share option on one share of Entity T stock on the grant date is $4, the compensation cost for the look-back option at the grant date is as follows:

0.15 of a share of nonvested stock ($30 × 0.15)	$4.50
Share option on 0.85 of a share of stock, exercise price of $30 ($4 × .85)	3.40
Total grant date value	$7.90

A217. For a look-back option on a dividend-paying share, both the value of the nonvested stock component and the value of the share option component would be adjusted to reflect the effect of the dividends that the employee does not receive during the life of the share option. The present value of the dividends expected to be paid on the stock during the life of the share option (one year in the example) would be deducted from the value of a share that receives dividends. One way to accomplish that is to base the value calculation on shares of stock rather than dollars by assuming that the dividends are reinvested in the stock.

A218. For example, if Entity T pays a quarterly dividend of 0.625 percent (2.5% ÷ 4) of the current share price, 1 share of stock would grow to 1.0252 (the future value of 1 using a return of 0.625 percent for 4 periods) shares at the end of the year if all dividends are reinvested. Therefore, the present value of 1 share of stock to be received in 1 year is only 0.9754 of a share today (again applying conventional compound interest formulas compounded quarterly) if the holder does not receive the dividends paid during the year.

A219. The value of the share option component is easier to compute; the appropriate dividend assumption is used in an option-pricing model in estimating the value of a share option on a whole share of stock. Thus, assuming the fair value of the share option is $3.60, the compensation cost for the look-back share option if Entity T pays quarterly dividends at the annual rate of 2.5 percent is as follows:

0.15 of a share of nonvested stock ($30 × 0.15 × 0.9754)	$4.39
Share option on 0.85 of a share of stock, $30 exercise price, 2.5% dividend yield ($3.60 × 0.85)	3.06
Total grant date value	$7.45

The first component, which is worth $4.39 at the grant date, is the minimum amount of benefits to the holder regardless of the price of the stock at the exercise date. The second component, worth $3.06 at the grant date, represents the additional benefit to the holder if the share price is above $30 at the exercise date.

Illustration 20—Employee Share Purchase Plans

A220. Paragraph 12 of this Statement stipulates the criteria that an employee share purchase plan must satisfy to be considered noncompensatory. One of those criteria specifies that substantially all employees that meet limited employment qualifications may participate on an equitable basis. Examples of limited employment qualifications might include customary employment of greater than 20 hours per week or completion of at least 6 months of service.

A221. Another criterion is that the terms are no more favorable than those available to all holders of the same class of shares. For example, Entity T offers all full-time employees and all nonemployee shareholders the right to purchase $10,000 of its common stock at a 5 percent discount from its market price at the date of purchase, which occurs in 1 month. The arrangement is not compensatory because its terms are no more favorable than those available to all holders of the same class of shares. In contrast, assume Entity C has a dividend reinvestment program that permits shareholders of its common stock the ability to reinvest dividends by purchasing shares of its common stock at a 10 percent discount from its market price on the date that dividends are distributed and Entity C offers all full-time employees the right to purchase annually up to $10,000 of its common stock at a 10 percent discount from its market price on the date of purchase. Entity C's common stock is widely held; hence, many shareholders will not receive dividends totaling at least $10,000 during the annual period. Assuming that the 10 percent discount cannot be justified as the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering, the arrangement is compensatory because the number of shares available to shareholders at a discount is based on the quantity of shares held and the amounts of dividends declared. Whereas, the number of shares available to employees at a discount is not dependent on shares held or declared dividends; therefore, the terms of the employee share purchase plan are more favorable than the terms available to all holders of the same class of shares. Consequently, the entire 10 percent discount to employees is compensatory. If, on the other hand, the 10 percent discount can be justified as the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering, then the entire 10 percent discount to employees is not compensatory.[115]

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[115]If an entity justifies a purchase discount in excess of 5 percent, it would be required to reassess that discount at least annually and no later than the first share purchase offer during the fiscal year. If upon reassessment that discount is not deemed justifiable, subsequent grants using that discount would be compensatory.

Illustration 21—Book Value Share Purchase Plans (Nonpublic Entities Only)

A222. Entity W, a nonpublic entity that is not an SEC registrant,[116] has two classes of stock: Class A is voting and held only by the members of the founding family, and Class B is nonvoting and held only by employees. The purchase price of Class B shares is a formula price based on book value. Class B shares require that the employee, six months after retirement or separation from the company, sell the shares back to the company for cash at a price determined by using the same formula used to establish the purchase price. Class B shares would be accounted for as liabilities pursuant to Statement 150 except during the indefinite deferral period established by FSP FAS 150-3, "Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity.*" Nevertheless, Class B shares may be classified as liabilities if they are granted as part of a share-based payment transaction and those shares contain certain repurchase features meeting criteria in paragraph 31 of this Statement; this example assumes that Class B shares do not meet those criteria.

A223. Determining whether a transaction involving Class B shares is compensatory will depend on the terms of the arrangement. For instance, if an employee acquires 100 shares of Class B stock in exchange for cash equal to the formula price of those shares, the transaction is not compensatory because the employee has acquired those shares on the same terms available to all other Class B shareholders and at the current formula price based on the current book value. Subsequent changes in the formula price of those shares held by the employee are not deemed compensation for services.

A224. However, if an employee acquires 100 shares of Class B stock in exchange for cash equal to 50 percent of the formula price of those shares, the transaction is compensatory because the employee is not paying the current formula price. Therefore, the value of the 50 percent discount should be attributed over the requisite service period. However, subsequent changes in the formula price of those shares held by the employee are not compensatory.

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[116]Because book value shares of public entities generally are not indexed to their stock prices, such shares would be classified as liabilities pursuant to this Statement.

Illustration 22—Liability Classification and the Interaction of This Statement with Statement 150

Applying the Classification Criteria in Statement 150

A225. Statement 150 excludes from its scope instruments that are accounted for under this Statement. Nevertheless, unless paragraphs 30–35 of this Statement require otherwise, an entity shall apply the classification criteria in paragraphs 8–14 of Statement 150, as they are effective at the reporting date, in determining whether to classify as a liability a freestanding financial instrument given to an employee in a share-based payment transaction.

A226. In determining the classification of an instrument, an entity shall take into account the deferrals contained in FSP FAS 150-3. In addition, a call option[117] written on an instrument that is not classified as a liability because of the deferrals in FSP FAS 150-3 (for example, a call option on a mandatorily redeemable share for which liability classification is deferred under FSP FAS 150-3) also shall be classified as equity while the deferral is in effect unless liability classification is required under the provisions of paragraph 32 of this Statement.

Classification of Certain Awards with Repurchase Features

A227. Statement 150 does not apply to outstanding shares embodying a conditional obligation to transfer assets, for example, shares that give the employee the right to require the employer to repurchase them for cash equal to their fair value (puttable shares). A puttable (or callable) share[118] awarded to an employee as compensation shall be classified as a liability if either of the following conditions is met: (a) the repurchase feature permits the employee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time from the date the

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[117]Refer to the definition of *share option* in Appendix E.

[118]A put right may be granted to the employee in a transaction that is related to a share-based compensation arrangement. If exercise of such a put right would require the entity to repurchase shares issued under the share-based compensation arrangement, the shares shall be accounted for as puttable shares. That treatment is consistent with the definition of a freestanding financial instrument in Appendix E. It also is consistent with the notion of accounting for the substantive terms of a share-based compensation transaction, which reflects the rights conveyed to the holder and the obligations imposed on the issuer, regardless of how the transaction is structured (paragraph 6).

share is issued,[119,120] or (b) it is probable that the employer would prevent the employee from bearing those risks and rewards for a reasonable period of time from the date the share is issued. For this purpose, a period of six months or more is a *reasonable period of time*. A puttable (or callable) share that does not meet either of those conditions shall be classified as equity.[121]

A228. For example, an entity may grant shares under a share-based compensation arrangement that the employee can put (sell) to the employer (the entity) shortly after the vesting date for cash equal to the fair value of the shares on the date of repurchase. That award of puttable shares would be classified as a liability because the repurchase feature permits the employee to avoid bearing the risks and rewards normally associated with equity share ownership for a reasonable period of time from the date the share is issued (condition (a) in paragraph A227). Alternatively, an entity might grant its own shares under a share-based compensation arrangement that may be put to the employer only after the employee has held them for a reasonable period of time after vesting but at a fixed redemption amount. Those puttable shares also would be classified as liabilities under the requirements of this Statement because the repurchase price is based on a fixed amount rather than variations in the fair value of the employer's shares. The employee cannot bear the risks and rewards normally associated with equity share ownership for a reasonable period of time because of that redemption feature. However, if a share with a repurchase feature gives the employee the right to sell shares back to the entity for a fixed amount over the fair value of the shares at the date of repurchase, paragraph 55 of this Statement requires that the fixed amount over the fair value be recognized as additional compensation cost over the requisite service period (with a corresponding liability being accrued).

A229. Options or similar instruments on shares (for example, options on puttable or mandatorily redeemable shares) shall be classified as liabilities if (a) the underlying shares are classified as liabilities or (b) the entity can be required under any circumstances to settle the option or similar instruments by transferring cash or other assets. For example, an entity may grant an option to an employee that, upon exercise,

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[119]A repurchase feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control (such as an initial public offering) would not meet condition (a) until it becomes probable that the event will occur within the reasonable period of time.

[120]An employee begins to bear the risks and rewards normally associated with equity share ownership when all the requisite service has been rendered.

[121]SEC registrants are required to consider the guidance in ASR No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks."* Under that guidance, shares subject to mandatory redemption requirements or whose redemption is outside the control of the issuer are classified outside permanent equity.

would be settled by issuing a mandatorily redeemable share that is not subject to the deferral in FSP FAS 150-3. Because the mandatorily redeemable share would be classified as a liability under Statement 150, the option also would be classified as a liability.

Subsequent Accounting for Certain Freestanding Financial Instruments

A230. Once the classification of an instrument is determined, the recognition and measurement provisions of this Statement shall be applied until the instrument ceases to be subject to the requirements discussed in paragraph A231 of this Statement. Statement 150 or other applicable GAAP, such as FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* applies to a freestanding financial instrument that was issued under a share-based payment arrangement but that is no longer subject to this Statement.[122]

A231. A freestanding financial instrument ceases to be subject to this Statement and becomes subject to the recognition and measurement requirements of Statement 150 or other applicable GAAP when the rights conveyed by the instrument to the holder are no longer dependent on the holder being an employee of the entity (that is, no longer dependent on providing service). That principle should be applied to specific types of instruments subject to Statement 150 or other applicable GAAP as illustrated by the following examples:

a. A mandatorily redeemable share becomes subject to Statement 150 or other applicable GAAP when an employee (a) has rendered the requisite service in exchange for the instrument and (b) could terminate the employment relationship and receive that share.
b. A share option or similar instrument that is not transferable and whose contractual term is shortened upon employment termination continues to be subject to this Statement until the rights conveyed by the instrument to the holder are no longer

[122]This guidance is not intended to suggest that all freestanding financial instruments should be accounted for as liabilities pursuant to Statement 150, but rather that freestanding financial instruments issued in share-based payment transactions may become subject to Statement 150 or other applicable GAAP depending on their substantive characteristics and when certain criteria in paragraph A231 are met.

dependent on the holder being an employee of the entity (generally, when the instrument is exercised).[123,124]

A232. An entity may modify (including cancel and replace) or settle a fully vested, freestanding financial instrument after it becomes subject to Statement 150 or other applicable GAAP. Such a modification or settlement shall be accounted for under the provisions of this Statement unless it applies equally to all financial instruments of the same class regardless of whether the holder is (or was) an employee (or an employee's beneficiary).[125] Following the modification, the instrument continues to be accounted for under Statement 150 or other applicable GAAP.

Illustration 23—Effective Dates and Transition Methods

Illustration 23(a)—Effective Dates and Transition Methods

A233. Tables 10–13 summarize guidance on the various transition methods permitted by this Statement and their relationship to its required effective dates.

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[123]A share option or similar instrument may become subject to Statement 150 or other applicable GAAP prior to its settlement. For instance, if a vested share option becomes exercisable for one year after employment termination, the rights conveyed by the instrument to the holder would no longer be dependent on the holder being an employee of the entity upon the employee's termination.

[124]Vested share options are typically exercisable for a short period of time (generally, 60 to 90 days) subsequent to the termination of the employment relationship. Notwithstanding the requirements of paragraph A231, such a provision, in and of itself, shall not cause the award to become subject to other applicable GAAP for that short period of time.

[125]A modification or settlement of a class of financial instrument that is designed exclusively for and held only by current or former employees (or their beneficiaries) may stem from the employment relationship depending on the terms of the modification or settlement. Thus, such a modification or settlement may be subject to the requirements of this Statement.

Table 10—Effective Dates and Transition Methods

Entity Classification[126,127]	First Applicable Reporting Period	Required Effective Date[128] (Periods Beginning After)	Transition Method at Required Effective Date	Optional Transition Method for Periods Prior to the Required Effective Date	
				MRA—All Periods[129]	MRA—Q1[130]
Public	Interim or Annual	6/15/05	MPA	MRA	MRA
SBI	Interim or Annual	12/15/05	MPA	MRA	MRA
NP-FV	Annual	12/15/05	MPA	MRA	N/A
ONP	Annual	12/15/05	Prospective	N/A	N/A

Tables 11–13 consider the impact of using the transition methods described in Table 10 on Entity D, which has a December 31 year-end for financial reporting purposes and has regularly granted share-based payment awards with 4-year cliff vesting service conditions in each of the past 10 years. Entity D is a public entity that does not file as a small business issuer and that has accounted for all share-based payment awards using Opinion 25.

[126]Entities are classified by the following designations: Public (a public entity as defined in Appendix E that does not file as a small business issuer, which also is defined in Appendix E), SBI (a public entity as defined in Appendix E that files as a small business issuer), NP-FV (a nonpublic entity as defined in Appendix E that has adopted Statement 123's fair-value-based method for recognition or pro forma disclosures prior to the effective date of this Statement), and ONP (a nonpublic entity other than NP-FV).

[127]This table also applies to *foreign private issuers* (as defined in SEC Regulation C §230.405) that are Public (as designated in the preceding footnote). Foreign private issuers should initially apply this Statement no later than the interim (quarterly or other) or annual period beginning after the specified effective date for which U.S. GAAP financial information is required or reported voluntarily.

[128]Early adoption is encouraged, provided that the financial statements or interim reports for the periods before the required effective date have not been issued.

[129]The phrase *MRA–all periods* refers to an entity that adopts this Statement using the modified retrospective application method for all periods pursuant to Statement 123's original effective date (paragraph 76).

[130]The phrase *MRA–Q1* refers to an entity that adopts this Statement using a modified retrospective application method only for the annual period of this Statement's adoption (paragraph 76).

Table 11—Example of Public Entity—December 31 Year-End: MPA

Reporting Period	Description of Effect of Using MPA Transition Method as of the Required Effective Date
1st Quarter 2005	Entity D recognizes compensation cost pursuant to Opinion 25 and includes disclosures pursuant to Statement 148.
2nd Quarter 2005	Entity D recognizes compensation cost pursuant to Opinion 25 and includes disclosures pursuant to Statement 148.
3rd Quarter 2005	Entity D applies this Statement to new awards granted and to modifications, repurchases, or cancellations on or after July 1, 2005. Compensation cost for the portion of awards for which the requisite service has not been rendered that are outstanding at July 1, 2005, shall be recognized using the measurement and attribution used for Statement 123's required pro forma disclosures as those services are received on or after July 1, 2005. If applicable, Entity D would recognize any cumulative effect adjustment as of July 1, 2005.
4th Quarter 2005	Same as 3rd quarter, except there would be no cumulative effect adjustment.
2005 Annual	For the year ended December 31, 2005, the financial statements reflect compensation cost pursuant to Opinion 25 for the first six months of the year and pursuant to this Statement for the second six months of the year.[131] The annual required pro forma disclosure reflects the recognition of compensation cost for the entire annual period. 2003 and 2004 would retain Opinion 25 and provide Statement 123's required pro forma disclosures.

[131]If an entity adopts this Statement using the modified prospective application method, an entity may not have information for an entire annual period. This Statement does not provide explicit guidance on how an entity should modify its annual disclosures in that event. An entity shall use judgment in applying this Statement's disclosure objectives and disclose that information deemed necessary for financial statement users to understand share-based payment transactions in the annual period of adoption and the impact of adopting this Statement.

Table 12—Example of Public Entity—December 31 Year-End: MRA—All Periods

Reporting Period	Description of Effect of Using MRA—All Periods Transition Method as of the Required Effective Date
1st Quarter 2005	Entity D recognizes compensation cost pursuant to Opinion 25 and includes disclosures pursuant to Statement 148.
2nd Quarter 2005	Entity D recognizes compensation cost pursuant to Opinion 25 and includes disclosures pursuant to Statement 148.
3rd Quarter 2005	Same as 3rd quarter in Table 11, and Entity D would adjust financial statements for all periods prior to July 1, 2005, to give effect to the fair-value-based method of accounting for awards granted, modified, or settled in cash in fiscal years beginning after December 15, 1994, on a basis consistent with the pro forma disclosures required for those periods by Statement 123. For the nine months ended September 30, 2005, the financial statements reflect compensation cost as calculated under Statement 123 in the first six months of the year and under this Statement for the 3rd quarter of the year. Beginning balances should be adjusted for the earliest year presented to reflect MRA to those prior years not presented.
4th Quarter 2005	Same as 3rd quarter, except there would be no cumulative effect adjustment or adjustment of beginning balances.
2005 Annual	For the year ended December 31, 2005, the financial statements reflect compensation cost pursuant to Statement 123 for the first six months of the year and pursuant to this Statement for the second six months of the year. Fiscal years 2003 and 2004 would be adjusted to reflect compensation cost to give effect to the fair-value-based method of accounting for awards granted, modified, or settled in cash in fiscal years beginning after December 15, 1994, on a basis consistent with the pro forma disclosures required for those periods by Statement 123.
2006	Entity D's 2005 quarterly financial information presented for comparative purposes would reflect the adjustments made for the application of the MRA method to those periods.

Table 13—Example of Public Entity—December 31 Year-End: MRA—Q1

Reporting Period	Description of Effect of Using MRA—Q1 Transition Method as of the Required Effective Date
1st Quarter 2005	Entity D recognizes compensation cost pursuant to Opinion 25 and includes disclosures pursuant to Statement 148.
2nd Quarter 2005	Entity D recognizes compensation cost pursuant to Opinion 25 and includes disclosures pursuant to Statement 148.
3rd Quarter 2005	Same as 3rd quarter in Table 11, and Entity D would recognize compensation cost for the first two quarters of 2005 using its Statement 123 pro forma disclosure amounts. For the nine months ended September 30, 2005, the financial statements reflect compensation cost pursuant to Statement 123 for the first six months of the year and pursuant to this Statement for the 3rd quarter of the year.
4th Quarter 2005	Same as 3rd quarter, except there would be no cumulative effect adjustment.
2005 Annual	For the year ended December 31, 2005, the financial statements reflect compensation cost pursuant to Statement 123 for the first six months of the year and pursuant to this Statement for the second six months of the year. Fiscal years 2003 and 2004 would retain Opinion 25 and provide Statement 123's required pro forma disclosures.
2006	Entity D's 2005 quarterly financial information presented for comparative purposes would reflect the adjustments made for the application of the MRA method to those periods.

Illustration 23(b)—Transition Using the Modified Prospective Method

A234. Entity Z, a public company, granted SARs to certain employees on July 1, 2003, based on 100,000 shares and accounts for them under Opinion 25's intrinsic value method. The base price of $10 per share was equal to the fair value of the stock on July 1, 2003. The SARs provide the employees with the right to receive, at the date the rights are exercised, shares having a then-current value equal to the market appreciation since the grant date. The employees do not have the ability to receive a cash

payment.[132] All of the rights vest at the end of three years and must be exercised one day after vesting. Entity Z's fiscal year ends on June 30 for financial reporting purposes. Entity Z adopts this Statement on July 1, 2005, using modified prospective application.

A235. The underlying stock price, compensation cost recognized, and related deferred tax benefit recognized under the intrinsic value method of Opinion 25 are as follows:

	2004	**2005**
Stock price at June 30	$12	$14
Compensation cost recognized	$66,667[133]	$200,000[134]
Deferred tax benefit at a 50 percent enacted tax rate	$33,333	$100,000

As of June 30, 2005, Entity Z has recognized a deferred tax asset of $133,333 ($33,333 + $100,000) and has increased additional paid-in capital by $266,667 ($66,667 + $200,000).

A236. The fair value on the grant date was $2.10 per SAR, or $210,000 ($2.10 × 100,000). Had Entity Z applied the fair-value-based method of accounting from the grant date, it would have recognized the following amounts related to the July 1, 2003, award:

	2004	**2005**
Compensation cost	$70,000[135]	$70,000
Deferred tax benefit at a 50 percent enacted tax rate	$35,000	$35,000

Under the fair-value-based method, Entity Z would have recognized a deferred tax asset at June 30, 2005, of $70,000 ($35,000 + $35,000) and an increase in additional paid-in capital of $140,000 ($70,000 + $70,000).

A237. As of July 1, 2005, when Entity Z adopts the fair-value-based method using the MPA, Entity Z estimates the number of equity instruments for which the requisite service is not expected to be rendered and recognizes, net of any related tax effect, an amount equal to the compensation cost that would not have been recognized in periods

[132] Net-share-settled SARs are generally accounted for as equity instruments (unless such shares are liabilities themselves).

[133] ($12 – $10) × 100,000 × ⅓ = $66,667

[134] ($14 – $10) × 100,000 × ⅔ – $66,667 = $200,000

[135] $210,000 × ⅓ = $70,000

prior to the effective date for those instruments that are not expected to vest as a cumulative effect of a change in accounting principle to the extent that compensation cost had been recognized for those awards. To the extent that any contra-equity balances for unearned compensation cost had been recorded that are related to Entity Z's stock-based compensation arrangements, those balances would be charged against additional paid-in capital. There are no other transition adjustments necessary at July 1, 2005, as a result of adopting this Statement.

A238. During the 2006 fiscal year, Entity Z will recognize additional compensation cost of $70,000, and will have a deferred tax asset at June 30, 2006, of $168,333, consisting of $133,333 related to compensation cost recognized under Opinion 25 and $35,000 related to compensation cost recognized under this Statement. The awards will be fully vested on June 30, 2006.

A239. On July 1, 2006, Entity Z's stock price is $20 per share and all of the 100,000 SARs are exercised. Based on the exercise-date intrinsic value of $10 per share, Entity Z recognizes an aggregate tax deduction of $1 million (100,000 SARs × ($20 – $10) appreciation), which is equal to the fair value of the shares issued to the employees. On a cumulative basis, Entity Z has recognized a deferred tax asset of $168,333. Total compensation cost recognized for the awards is $336,667, consisting of $266,667 recognized under Opinion 25 and $70,000 recognized under this Statement. On July 1, 2006, the following entries are made upon exercise:

Deferred tax expense	$168,333	
Deferred tax asset		$168,333

To write off the deferred tax asset related to the SARs.

Current taxes payable	$500,000	
Current tax expense		$168,333
Additional paid-in capital		$331,667

To adjust current tax expense and current taxes payable to recognize the current tax benefit from deductible compensation cost upon exercise of SARs. The credit to additional paid-in capital is the excess tax benefit that results from the excess of the deductible amount over the compensation cost recognized [($1,000,000 – $336,667) × .50 = $331,667].

MINIMUM DISCLOSURE REQUIREMENTS AND ILLUSTRATIVE DISCLOSURES

A240. The minimum information needed to achieve the disclosure objectives in paragraph 64 of this Statement is set forth below. To achieve those objectives, an entity should disclose the following information:[136]

a. A description of the share-based payment arrangement(s), including the general terms of awards under the arrangement(s), such as the requisite service period(s) and any other substantive conditions (including those related to vesting), the maximum contractual term of equity (or liability) share options or similar instruments, and the number of shares authorized for awards of equity share options or other equity instruments. An entity shall disclose the method it uses for measuring compensation cost from share-based payment arrangements with employees.
b. For the most recent year for which an income statement is provided:
   (1) The number and weighted-average exercise prices (or conversion ratios) for each of the following groups of share options (or share units): (a) those outstanding at the beginning of the year, (b) those outstanding at the end of the year, (c) those exercisable or convertible at the end of the year, and those (d) granted, (e) exercised or converted, (f) forfeited, or (g) expired during the year.
   (2) The number and weighted-average grant-date fair value (or calculated value for a nonpublic entity that uses that method or intrinsic value for awards measured pursuant to paragraphs 24 and 25 of this Statement) of equity instruments not specified in paragraph A240(b)(1) (for example, shares of nonvested stock), for each of the following groups of equity instruments: (a) those nonvested at the beginning of the year, (b) those nonvested at the end of the year, and those (c) granted, (d) vested, or (e) forfeited during the year.

[136]In some circumstances, an entity may need to disclose information beyond that listed in this paragraph to achieve the disclosure objectives.

c. For each year for which an income statement is provided:
   (1) The weighted-average grant-date fair value (or calculated value for a nonpublic entity that uses that method or intrinsic value for awards measured at that value pursuant to paragraphs 24 and 25 of this Statement) of equity options or other equity instruments granted during the year.
   (2) The total intrinsic value of options exercised (or share units converted), share-based liabilities paid, and the total fair value of shares vested during the year.
d. For fully vested share options (or share units) and share options expected to vest at the date of the latest statement of financial position:
   (1) The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value, and weighted-average remaining contractual term of options (or share units) outstanding.
   (2) The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value (except for nonpublic entities), and weighted-average remaining contractual term of options (or share units) currently exercisable (or convertible).
e. For each year for which an income statement is presented:[137]
   (1) A description of the method used during the year to estimate the fair value (or calculated value) of awards under share-based payment arrangements.
   (2) A description of the significant assumptions used during the year to estimate the fair value (or calculated value) of share-based compensation awards, including (if applicable):
      (a) Expected term of share options and similar instruments, including a discussion of the method used to incorporate the contractual term of the instruments and employees' expected exercise and post-vesting employment termination behavior into the fair value (or calculated value) of the instrument.
      (b) Expected volatility of the entity's shares and the method used to estimate it. An entity that uses a method that employs different volatilities during the contractual term shall disclose the range of expected volatilities used and the weighted-average expected volatility. A nonpublic entity that uses the calculated value method should disclose the reasons why it is not practicable for it to estimate the expected volatility of its share price, the appropriate industry sector index that it has selected, the reasons for selecting that particular index, and how it has calculated historical volatility using that index.

[137] An entity that uses the intrinsic value method pursuant to paragraphs 24 and 25 of this Statement is not required to disclose the following information for awards accounted for under that method.

(c) Expected dividends. An entity that uses a method that employs different dividend rates during the contractual term shall disclose the range of expected dividends used and the weighted-average expected dividends.

(d) Risk-free rate(s). An entity that uses a method that employs different risk-free rates shall disclose the range of risk-free rates used.

(e) Discount for post-vesting restrictions and the method for estimating it.

f. An entity that grants equity or liability instruments under multiple share-based payment arrangements with employees shall provide the information specified in paragraphs A240(a)–(e) separately for different types of awards to the extent that the differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of share-based compensation. For example, separate disclosure of weighted-average exercise prices (or conversion ratios) at the end of the year for options (or share units) with a fixed exercise price (or conversion ratio) and those with an indexed exercise price (or conversion ratio) could be important. It also could be important to segregate the number of options (or share units) not yet exercisable into those that will become exercisable (or convertible) based solely on fulfilling a service condition and those for which a performance condition must be met for the options (share units) to become exercisable (convertible). It could be equally important to provide separate disclosures for awards that are classified as equity and those classified as liabilities.

g. For each year for which an income statement is presented:

(1) Total compensation cost for share-based payment arrangements (a) recognized in income as well as the total recognized tax benefit related thereto and (b) the total compensation cost capitalized as part of the cost of an asset.

(2) A description of significant modifications, including the terms of the modifications, the number of employees affected, and the total incremental compensation cost resulting from the modifications.

h. As of the latest balance sheet date presented, the total compensation cost related to nonvested awards not yet recognized and the weighted-average period over which it is expected to be recognized.

i. If not separately disclosed elsewhere, the amount of cash received from exercise of share options and similar instruments granted under share-based payment arrangements and the tax benefit realized from stock options exercised during the annual period.

j. If not separately disclosed elsewhere, the amount of cash used to settle equity instruments granted under share-based payment arrangements.

k. A description of the entity's policy, if any, for issuing shares upon share option exercise (or share unit conversion), including the source of those shares (that is, new shares or treasury shares). If as a result of its policy, an entity expects to repurchase

shares in the following annual period, the entity shall disclose an estimate of the amount (or a range, if more appropriate) of shares to be repurchased during that period.

A241. An illustration of disclosures of a public entity's share-based compensation arrangements follows. The illustration assumes that compensation cost has been recognized in accordance with this Statement for several years. The amount of compensation cost recognized each year includes both costs from that year's grants and costs from prior years' grants. The number of options outstanding, exercised, forfeited, or expired each year includes options granted in prior years.

* * *

On December 31, 20Y1, the Entity has two share-based compensation plans, which are described below. The compensation cost that has been charged against income for those plans was $29.4 million, $28.7 million, and $23.3 million for 20Y1, 20Y0, and 20X9, respectively. The total income tax benefit recognized in the income statement for share-based compensation arrangements was $10.3 million, $10.1 million, and $8.2 million for 20Y1, 20Y0, and 20X9, respectively. Compensation cost capitalized as part of inventory and fixed assets for 20Y1, 20Y0, and 20X9 was $0.5 million, $0.2 million, and $0.4 million, respectively.

Share Option Plan

The Entity's 20X4 Employee Share Option Plan (the Plan), which is shareholder-approved, permits the grant of share options and shares to its employees for up to 8 million shares of common stock. The Entity believes that such awards better align the interests of its employees with those of its shareholders. Option awards are generally granted with an exercise price equal to the market price of the Entity's stock at the date of grant; those option awards generally vest based on 5 years of continuous service and have 10-year contractual terms. Share awards generally vest over five years. Certain option and share awards provide for accelerated vesting if there is a change in control (as defined in the Plan).

The fair value of each option award is estimated on the date of grant using a lattice-based option valuation model that uses the assumptions noted in the following table. Because lattice-based option valuation models incorporate ranges of assumptions for inputs, those ranges are disclosed. Expected volatilities are based on implied volatilities from traded options on the Entity's stock, historical volatility of the Entity's stock, and other factors. The Entity uses historical data to estimate option exercise and employee termination within the valuation model; separate groups of employees that have similar historical exercise behavior are considered separately for valuation

purposes. The expected term of options granted is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding; the range given below results from certain groups of employees exhibiting different behavior. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

	20Y1	**20Y0**	**20X9**
Expected volatility	25%–40%	24%–38%	20%–30%
Weighted-average volatility	33%	30%	27%
Expected dividends	1.5%	1.5%	1.5%
Expected term (in years)	5.3–7.8	5.5–8.0	5.6–8.2
Risk-free rate	6.3%–11.2%	6.0%–10.0%	5.5%–9.0%

A summary of option activity under the Plan as of December 31, 20Y1, and changes during the year then ended is presented below:

Options	**Shares (000)**	**Weighted-Average Exercise Price**	**Weighted-Average Remaining Contractual Term**	**Aggregate Intrinsic Value ($000)**
Outstanding at January 1, 20Y1	4,660	$42		
Granted	950	60		
Exercised	(800)	36		
Forfeited or expired	(80)	59		
Outstanding at December 31, 20Y1	4,730	$47	6.5	$85,140
Exercisable at December 31, 20Y1	3,159	$41	4.0	$75,816

The weighted-average grant-date fair value of options granted during the years 20Y1, 20Y0, and 20X9 was $19.57, $17.46, and $15.90, respectively. The total intrinsic value of options exercised during the years ended December 31, 20Y1, 20Y0, and 20X9, was $25.2 million, $20.9 million, and $18.1 million, respectively.

A summary of the status of the Entity's nonvested shares as of December 31, 20Y1, and changes during the year ended December 31, 20Y1, is presented below:

Nonvested Shares	Shares (000)	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 20Y1	980	$40.00
Granted	150	63.50
Vested	(100)	35.75
Forfeited	(40)	55.25
Nonvested at December 31, 20Y1	990	$43.35

As of December 31, 20Y1, there was $25.9 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over a weighted-average period of 4.9 years. The total fair value of shares vested during the years ended December 31, 20Y1, 20Y0, and 20X9, was $22.8 million, $21 million, and $20.7 million, respectively.

During 20Y1, the Entity extended the contractual life of 200,000 fully vested share options held by 10 employees. As a result of that modification, the Entity recognized additional compensation expense of $1.0 million for the year ended December 31, 20Y1.

Performance Share Option Plan

Under its 20X7 Performance Share Option Plan (the Performance Plan), which is shareholder-approved, each January 1 the Entity grants selected executives and other key employees share option awards whose vesting is contingent upon meeting various departmental and company-wide performance goals, including decreasing time to market for new products, revenue growth in excess of an index of competitors' revenue growth, and sales targets for Segment X. Share options under the Performance Plan are generally granted at-the-money, contingently vest over a period of 1 to 5 years, depending on the nature of the performance goal, and have contractual lives of 7 to 10 years. The number of shares subject to options available for issuance under this plan cannot exceed five million.

The fair value of each option grant under the Performance Plan was estimated on the date of grant using the same option valuation model used for options granted under the Plan and assumes that performance goals will be achieved. If such goals are not met, no compensation cost is recognized and any recognized compensation cost is reversed. The inputs for expected volatility, expected dividends, and risk-free rate used in estimating those options' fair value are the same as those noted in the table related to

options issued under the Share Option Plan. The expected term for options granted under the Performance Plan in 20Y1, 20Y0, and 20X9 is 3.3 to 5.4 years, 2.4 to 6.5 years, and 2.5 to 5.3 years, respectively.

A summary of the activity under the Performance Plan as of December 31, 20Y1, and changes during the year then ended is presented below:

Performance Options	**Shares (000)**	**Weighted-Average Exercise Price**	**Weighted-Average Remaining Contractual Term**	**Aggregate Intrinsic Value ($000)**
Outstanding at January 1, 20Y1	2,533	$44		
Granted	995	60		
Exercised	(100)	36		
Forfeited	(604)	59		
Outstanding at December 31, 20Y1	2,824	$47	7.1	$50,832
Exercisable at December 31, 20Y1	936	$40	5.3	$23,400

The weighted-average grant-date fair value of options granted during the years 20Y1, 20Y0, and 20X9 was $17.32, $16.05, and $14.25, respectively. The total intrinsic value of options exercised during the years ended December 31, 20Y1, 20Y0, and 20X9, was $5 million, $8 million, and $3 million, respectively. As of December 31, 20Y1, there was $16.9 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Performance Plan; that cost is expected to be recognized over a period of 4.0 years.

Cash received from option exercise under all share-based payment arrangements for the years ended December 31, 20Y1, 20Y0, and 20X9, was $32.4 million, $28.9 million, and $18.9 million, respectively. The actual tax benefit realized for the tax deductions from option exercise of the share-based payment arrangements totaled $11.3 million, $10.1 million, and $6.6 million, respectively, for the years ended December 31, 20Y1, 20Y0, and 20X9.

The Entity has a policy of repurchasing shares on the open market to satisfy share option exercises and expects to repurchase approximately one million shares during 20Y2, based on estimates of option exercises for that period.

Supplemental Disclosures

A242. In addition to the information required by this Statement, an entity may disclose supplemental information that it believes would be useful to investors and creditors, such as a range of values calculated on the basis of different assumptions, provided that the supplemental information is reasonable and does not lessen the prominence and credibility of the information required by this Statement. The alternative assumptions should be described to enable users of the financial statements to understand the basis for the supplemental information.

Appendix B

BASIS FOR CONCLUSIONS

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Appendix B

BASIS FOR CONCLUSIONS

INTRODUCTION

B1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

WHY THE BOARD UNDERTOOK A PROJECT TO RECONSIDER STATEMENT 123

Statement 123's Provisions on Cost Recognition for Share-Based Payment Arrangements

B2. Statement 123 was issued in 1995. Its requirements for share-based employee compensation transactions were effective for financial statements for fiscal years beginning after December 15, 1995. As originally issued, Statement 123 established the fair-value-based method of accounting as preferable for share-based compensation awarded to employees and encouraged, but did not require, entities to adopt it. The Board's decision at that time was based on practical rather than conceptual considerations. Paragraphs 60 and 61 of Statement 123 stated:

> The debate on accounting for stock-based compensation unfortunately became so divisive that it threatened the Board's future working relationship with some of its constituents. Eventually, the nature of the debate threatened the future of accounting standards setting in the private sector.
>
> The Board continues to believe that financial statements would be more relevant and representationally faithful if the estimated fair value of employee stock options was included in determining an entity's net income, just as all other forms of compensation are included. To do so would be consistent with accounting for the cost of all other goods and services received as consideration for equity instruments. The Board also believes that financial reporting would be improved if all equity instruments granted to employees, including instruments with variable features such as options with performance criteria for vesting, were accounted for

> on a consistent basis. However, in December 1994, the Board decided that the extent of improvement in financial reporting that was envisioned when this project was added to its technical agenda and when the Exposure Draft was issued was not attainable because the deliberate, logical consideration of issues that usually leads to improvement in financial reporting was no longer present. Therefore, the Board decided to specify as preferable and to encourage but not to require recognition of compensation cost for all stock-based employee compensation, with required disclosure of the pro forma effects of such recognition by entities that continue to apply Opinion 25.

B3. Statement 123 allowed entities to continue accounting for share-based compensation arrangements with employees according to the intrinsic value method in APB Opinion No. 25, *Accounting for Stock Issued to Employees,* under which no compensation cost was recognized for employee share options that met specified criteria. Public entities that continued to use the intrinsic value method were required to disclose pro forma measures of net income and earnings per share as if they had used the fair-value-based method. Nonpublic entities that continued to use the intrinsic value method were required to make pro forma disclosures as if they had used the minimum value method or the fair-value-based method for recognition.

Pertinent Events during the First Eight Years Statement 123 Was Applicable

B4. Before 2002, virtually all entities chose to continue to apply the provisions of Opinion 25 rather than to adopt the fair-value-based method to account for share-based compensation arrangements with employees. The serious financial reporting failures that came to light beginning in 2001 led to a keen interest in accounting and financial reporting issues on the part of investors, regulators, members of the U.S. Congress, and the media. Many of the Board's constituents who use financial information said that the failure to recognize compensation cost for most employee share options had obscured important aspects of reported performance and impaired the transparency of financial statements.

B5. The increased focus on high-quality, transparent financial reporting stemming from the financial reporting failures in the early years of the 21st century created a growing demand for entities to recognize compensation cost for employee share options and similar instruments—a demand to which entities began to respond. As of March 2003, when the Board added this project to its agenda, 179 public companies had adopted or announced their intention to adopt the fair-value-based accounting method in Statement 123. By May 2003, that number had grown to 276 public companies, of which 93 were companies included in the Standard & Poor's (S&P) 500

Index; those companies represented 36 percent of the index based on market capitalization.[138] By February 2004, the number had increased to 483 public companies, 113 of which represented 41 percent of the S&P 500 index based on market capitalization, and by July 2004, the number had increased to 753 public companies.

B6. The increased focus on financial reporting issues, including accounting for share-based compensation arrangements with employees, was accompanied by numerous requests from investors, regulators, and other users of financial statements for the Board to reconsider the cost recognition provisions of Statement 123. Although an increasing number of entities were voluntarily adopting the fair-value-based accounting method in Statement 123, it did not appear likely that voluntary adoption would extend to all entities, at least not in the foreseeable future. Voluntary adoption of Statement 123's fair-value-based accounting method by increasing numbers of entities provided improved information about the effects of share-based payment arrangements with employees on those entities and their shareholders. However, that voluntary adoption also resulted in less comparability across entities because of the alternative accounting methods Statement 123 permitted.

B7. The existence of alternative accounting methods for share-based compensation arrangements with employees, coupled with the failure of Opinion 25 to provide much general guidance on applying its intrinsic value method, had resulted in voluminous accounting guidance that constituents said was disjointed, rule-based, and form-driven.[139] Both the Board and the Emerging Issues Task Force (EITF) had responded to requests for guidance on a large number of implementation issues. For example, FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation,* addressed 20 implementation questions, many of which had 1 or more subquestions. The EITF addressed an additional 51 implementation issues in EITF Issue No. 00-23, "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44." Constituents asked the Board to simplify the existing accounting guidance on accounting for share-based payment arrangements, and some of those constituents noted that eliminating the alternative to continue using Opinion 25's accounting method would be the best way to achieve that simplification.

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[138]Refer to Pat McConnell, Janet Pegg, Chris Senyek, and Dane Mott, "Companies That Currently Expense or Intend to Expense Stock Options Using the Fair Value Method," Bear Stearns (May 23, 2003), Bear Stearns update (February 12, 2004), and Bear Stearns update (July 20, 2004).

[139]That guidance was identified by the United States Securities and Exchange Commission (SEC) as an example of rules-based accounting standards. (SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System,* March 25, 2003 [www.sec.gov/news/studies/principlesbasedstand.htm]).

B8. In November 2002, the International Accounting Standards Board (IASB) issued an Exposure Draft, *Share-based Payment,* (ED2) that proposed a single, fair-value-based method to be used to account for all share-based compensation arrangements. Although the method that the IASB proposed in ED2 shared some important features of the fair-value-based method in Statement 123, it also differed in certain significant respects. Many of the differences involved secondary implementation issues rather than primary issues of fundamental principles.

B9. In November 2002, shortly after the IASB issued ED2, the FASB issued an 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. The Invitation to Comment explained both the primary and secondary differences between the requirements of Statement 123 and the method proposed by the IASB. Most users of financial statements who responded to the Invitation to Comment urged the Board to undertake a project to require that entities account for share-based payment arrangements with employees using a fair-value-based method. The majority of the preparers who responded did not support such a requirement. However, some of those preparers asked for additional guidance on applying the fair-value-based method in Statement 123.

B10. For the reasons discussed in paragraphs B4–B9, the Board concluded that the time had come to reconsider the provisions of Statement 123. Given that conclusion, the Board agreed with respondents to the Invitation to Comment that undertaking that reconsideration concurrently with the IASB's consideration of responses to ED2[140] would maximize the opportunity for convergence of U.S. and international accounting standards. Doing so would be consistent with the Board's commitment to work toward convergence to a set of high-quality accounting standards that can be used for both domestic and cross-border financial reporting.

Summary of Reasons for Undertaking a Project to Reconsider Statement 123

B11. After considering the factors discussed in paragraphs B4–B10, in March 2003, the Board added to its agenda a project to reconsider the existing guidance on accounting for share-based payment arrangements. This Statement is a result of that project. By requiring recognition of compensation cost for share-based payment arrangements with employees, this Statement responds to:

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[140]The IASB issued International Financial Reporting Standard (IFRS) 2, *Share-based Payment,* in February 2004. Refer to paragraphs B258–B269 of this appendix for a discussion of differences between this Statement and IFRS 2.

a. Requests from investors and others to improve the transparency, relevance, and comparability of information about the effects of share-based payment arrangements with employees on entities and their shareholders
b. The need to simplify the existing accounting guidance on share-based payment arrangements with employees by eliminating alternative accounting methods
c. The Board's commitment to work toward convergence to a set of high-quality accounting standards that can be used for both domestic and cross-border financial reporting.

SCOPE OF THIS STATEMENT

B12. As did Statement 123, this Statement includes in its scope all share-based payment transactions, whether with employees or with counterparties who are not employees (nonemployees). The FASB project from which this Statement results encompasses reconsideration of all aspects of accounting for share-based payment arrangements. However, the Board decided to exclude from the scope of this Statement reconsideration of the measurement date for share-based payment transactions with nonemployees, which also was excluded from the scope of Statement 123. This Statement also excludes from its scope accounting for employee share ownership plans currently accounted for under AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans.* In other words, this Statement reflects the Board's reconsideration of only those issues that were addressed in Statement 123.

B13. Most of the debate surrounding accounting for share-based payment has focused on arrangements with employees, and the Board concluded that mandating recognition of compensation cost measured at fair value for those arrangements was the most urgent aspect of this project. Moreover, cost is already recognized for share-based payment arrangements with nonemployees under Statement 123 and 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," using a fair-value-based measure, albeit with a measurement date that may differ from the one this Statement prescribes for equity instruments issued to employees. Including guidance on share-based payment arrangements with nonemployees and guidance on accounting for shares held by employee share ownership plans would have delayed the issuance of this Statement.

B14. The Board may reconsider the issues addressed in Issue 96-18 in a later phase of this project. Although this Statement addresses issues with a focus on share-based payment transactions with employees, certain of its provisions are unrelated to the

issues addressed in Issue 96-18. The Board understands that many entities have been analogizing to Statement 123's guidance in determining how to account for share-based payment transactions with nonemployees. However, because the Board did not specifically consider such items in the context of nonemployee transactions, it decided that, except for the amendment to Statement 95, no additional guidance should be provided in this Statement on accounting for share-based payment transactions with nonemployees.

RECOGNITION OF COMPENSATION COST FROM SHARE-BASED PAYMENT ARRANGEMENTS WITH EMPLOYEES

B15. The Board reaffirmed the conclusion reflected in Statement 123 that an entity should recognize compensation cost as a result of receiving employee services in exchange for valuable financial instruments, including equity share options. The reasons for that conclusion are discussed in paragraphs B16–B32. The Board also concluded that such compensation cost should be measured using a fair-value-based method similar to the one set forth in Statement 123. The reasons for the Board's conclusions on measurement of compensation cost are discussed in paragraphs B33–B60.

Employee Services Received in Exchange for Equity Instruments Qualify as Assets

B16. Some respondents to the Exposure Draft said that an entity does not receive an asset, and thus does not incur compensation cost, when it receives employee services in exchange for equity instruments. The Board disagrees; employers receive employee services in exchange for all forms of compensation paid. Those services, like services received from nonemployees, qualify as assets, if only momentarily because receipt of a service and its use occur simultaneously.

B17. FASB Concepts Statement No. 6, *Elements of Financial Statements,* paragraph 26, describes the three essential characteristics of an asset:

> . . . (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

Employee services clearly have the capacity, in combination with other assets such as equipment, plant, or intangibles, to contribute to the employer's future net cash inflows by producing a product, which may itself be a service that is sold to customers. The employer can obtain the benefit and control others' access to it; an employee cannot provide the same services to more than a single employer simultaneously. By the time employee services (and the related cost or expense) are recognized, the employer has obtained the benefit.

B18. To summarize, employee services qualify as assets because they exhibit the three essential characteristics of an asset described in Concepts Statement 6. If employee (and other) services did not provide economic benefits, an entity would not be willing to pay any form of consideration, including cash salaries, for them. The nature of the consideration exchanged for employee services is not significant in determining whether those services qualify as assets. The consumption of the services received in exchange for the issuance of equity instruments (or the payment of assets) is the event that gives rise to compensation cost.[141]

Employee Services Exchanged for Equity Instruments Give Rise to Compensation Cost As Those Services Are Used

B19. Because an entity cannot store services, they qualify as separate or independent assets only momentarily. An entity's use of an asset results in an expense, regardless of whether the asset is cash or another financial instrument, goods, or services. (Generally accepted accounting principles in the United States require the cost of services to be capitalized as part of the cost of another asset in certain circumstances. In that situation, expense is recognized when that other asset, for example, inventory, is consumed or disposed of.) Concepts Statement 6, paragraph 81, footnote 43, notes that, in concept, most expenses decrease assets rather than increase liabilities. However, if receipt of an asset, such as services, and its use occur virtually simultaneously, the asset often is not recognized because it would be derecognized immediately.[142]

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[141]Concepts Statement 6, paragraph 79, footnote 40, explains that point as follows: "Entities acquire assets (economic benefits), not expenses or losses, to carry out their production operations, and most expenses are at least momentarily assets. Since many goods and services acquired are used either simultaneously with acquisition or soon thereafter, it is common practice to record them as expenses at acquisition. However, to record an expense as resulting from incurring a liability is a useful shortcut that combines two conceptually separate events: (a) an exchange transaction in which an asset was acquired and (b) an internal event (production) in which an asset was used up."

[142]That footnote refers only to liabilities, but the same is true for equity. That is, issuing equity increases assets rather than resulting in an expense. The entity obtains assets in exchange for issuing equity instruments. For ease of discussion, this appendix also generally omits references to the interim step of recognizing an asset and uses shorthand phrases such as *the compensation cost resulting from awards of share-based compensation.*

B20. Some who do not consider required cost recognition to be appropriate contend that the issuance of an employee share option is a transaction directly between the recipient and the preexisting shareholders. The Board disagrees. Employees provide services to the entity—not directly to individual shareholders—as consideration for their options. Carried to its logical conclusion, that view would imply that the issuance of virtually any equity instrument for goods or services, rather than for cash or other financial instruments, should not affect the issuer's financial statements. For example, no asset or related cost would be reported if shares of stock were issued to acquire legal or consulting services, tangible assets, or an entire business in a business combination. To omit such assets and the related costs would give a misleading picture of the entity's financial position and financial performance.

B21. To summarize, accounting for assets received (and the related expenses when the assets are consumed) has long been fundamental to the accounting for all freestanding equity instruments except one—fixed equity share options that had no intrinsic value at the grant date and were accounted for under the requirements of Opinion 25. This Statement remedies that exception.

Disclosure versus Recognition

B22. Having reaffirmed the conclusion that compensation cost from awards of equity instruments to employees, measured using the fair-value-based method, qualifies for recognition in the financial statements, the Board considered whether to eliminate the alternative to disclose, on a pro forma basis, the effects of that accounting in lieu of applying it for recognition purposes. Some respondents to the Exposure Draft and the Invitation to Comment said that the pro forma disclosures required by Statement 123 provided adequate financial information about share-based payment arrangements with employees. Similar comments were made in various public venues during the Board's work leading to the issuance of this Statement. Some of those commentators asserted that whether information is disclosed in the notes or recognized in the financial statement is not important—either way, sophisticated users of financial information have access to the information they need.

Pro Forma Disclosure Is Not an Acceptable Substitute for Recognition

B23. The Board reaffirmed the conclusion in Statement 123 that pro forma disclosures are not an adequate substitute for recognition in the financial statements of compensation cost resulting from share-based payment arrangements with employees. Although the main reasons for that conclusion are essentially the same as in Statement 123, new information made available since the issuance of Statement 123 provided additional support for the Board's reasoning.

B24. Paragraph 9 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* discusses recognition and disclosure:

> Since recognition means depiction of an item in both words and numbers, with the amount included in the totals of the financial statements, disclosure by other means is *not* recognition. Disclosure of information about the items in financial statements and their measures that may be provided by notes or parenthetically on the face of financial statements, by supplementary information, or by other means of financial reporting is not a substitute for recognition in financial statements for items that meet recognition criteria.

B25. Most of the users of financial statements who responded to either the Exposure Draft or the Invitation to Comment, as well as those who responded to the IASB's ED2 or the Exposure Draft that led to the issuance of FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure,* strongly supported recognition of the cost of employee services received in exchange for equity instruments. Although the pro forma disclosures required by Statement 123 helped to mitigate the problems of nonrecognition of compensation cost, many financial statement users said that the failure of most entities to recognize that cost impaired the transparency, relevance, and comparability, as well as the credibility, of financial statements. In agreeing with those respondents, the Board noted that if disclosure and recognition were equal alternatives, the arguments for only disclosing the amount of compensation cost from share-based compensation arrangements with employees would apply equally to other costs incurred during a period, such as warranties, pensions, and other postretirement benefits. Disclosing but not recognizing those costs in the period in which they are incurred would cause reported net income to misrepresent the results of current operations.

B26. In addition to responses to the Exposure Draft, the Invitation to Comment, ED2, and the Exposure Draft that led to the issuance of Statement 148, the Board's conclusion that many users of financial statements support recognition of the cost of employee services received in exchange for share options and similar equity instruments was confirmed in a number of ways, including:

a. Numerous requests from users for the Board to add a project to its agenda to reconsider accounting for share-based payment arrangements with employees.

b. Responses to a survey of analysts and fund managers in 2001 by the Association for Investment Management and Research[143] (now the CFA Institute) in which 83 percent of respondents favored recognition of compensation cost for share-based payment arrangements with employees.
c. Responses to a recent survey[144] of 30 institutional investors in technology companies in which more than 90 percent supported recognition of compensation cost for employee share options. Approximately 70 percent of those analysts and portfolio managers also said that an analysis of an entity's share options is significant to their valuation of the entity and has the potential to influence their investment decisions.
d. Public comments made by various users of financial statements during the course of the Board's project on share-based payment.
e. Numerous nonbinding shareholder resolutions in which both institutional and individual investors urged entities to adopt Statement 123's fair-value-based method for recognition purposes.

Recognizing Compensation Cost for Employee Equity Share Options Does Not Inappropriately Double Count Their Effect

B27. Some respondents to the Invitation to Comment said that recognizing the cost of employee services received in exchange for employee share options would inappropriately "double count" the effect of granting share options. They noted that the dilutive effect of in-the-money share options is included in the denominator of diluted earnings per share. To reduce net income (the numerator of that ratio) by recognizing compensation expense based on fair value would, in their view, create an inappropriate dual effect on diluted earnings per share; this argument often is stated as "earnings per share would be hit twice."

B28. Earnings per share is a metric—no expense (cost), revenue, or other element of financial statements is "recognized" by including its effect only in earnings per share. A transaction that results in an expense and that also increases the number of common shares outstanding properly affects both the numerator and the denominator of earnings per share. An equity share option affects only potential dilutive common shares outstanding and thus affects only diluted earnings per share. If an entity issues equity shares, equity share options, or share purchase warrants for cash and uses the cash received to pay employee salaries, earnings are reduced and more actual or potential

[143]Association for Investment Management and Research (AIMR), "Survey on Accounting for Stock Options" (September 2001); electronic survey sent to more than 18,000 AIMR members worldwide to assess their response to a proposed agenda topic of the IASB.

[144]Merrill Lynch, "Tech Stock Options: The Invisible Cash Flow Drain" (February 3, 2004).

common shares are outstanding. Moreover, if an entity issues common shares in exchange for a depreciable asset, both the resulting depreciation expense and the increase in common shares outstanding reduce basic earnings per share. Recognition of the compensation cost resulting from awards of employee share options is no different from the accounting for other transactions in which use of the consideration received for issuing equity instruments reduces reported earnings, and the related equity instruments increase either actual or potential common shares outstanding.

Potential Economic Consequences of Recognition of Compensation Cost

B29. Some respondents said that required recognition of compensation cost based on the fair value of employee share options may have undesirable economic consequences. They suggested that required recognition of compensation cost is likely to cause some entities to reduce, eliminate, or otherwise revise those arrangements. Some also contended that recognition of compensation cost for employee share options will raise the cost of capital for entities that make extensive use of those options.

B30. The Board's operating precepts require it to consider issues in an evenhanded manner, without attempting to encourage or to discourage specific actions. That does not imply that improved financial reporting should have no economic consequences. To the contrary, a change in accounting standards that results in financial statements that are more relevant and representationally faithful, and thus more useful for decision making, presumably would have economic consequences. For example, required recognition of compensation cost based on the provisions of this Statement would result in more comparable accounting for all forms of employee compensation. As a result, any decision to reassess and perhaps modify existing share-based payment arrangements would be based on financial information that better represents the economic effects of various forms of compensation.

B31. The Board understands that the vast majority of share options awarded to employees are fixed, at-the-money options for which entities that continued to use the accounting requirements of Opinion 25 recognized no compensation expense. The accounting under Opinion 25 treated most fixed share options as though they were a "free good," which implies that the services received in exchange for those options were obtained without incurring a cost. But employee services received in exchange for share options are not free. Share options are valuable equity instruments for which valuable consideration is received—consideration that should be recognized regardless of whether it is in the form of cash, goods, or services from employees or other suppliers. Accounting for fixed, at-the-money employee share options as though they impose no cost on the entity that issues them may encourage their substitution for other forms of compensation, such as share options or other instruments with performance or

market conditions, that may be preferable in a particular situation. Requiring recognition of compensation cost using the fair-value-based method increases the neutrality of financial reporting and removes what many consider to be an accounting incentive for an entity to choose a form of employee compensation—fixed, at-the-money share options—that may not be the most advantageous in its circumstances.

Conclusion on Recognition of Compensation Cost

B32. In summary, the Board reaffirmed the conclusions reflected in Statement 123 that:

a. Employee services exchanged for equity share options and other equity instruments give rise to a cost that is properly recognized in the issuing entity's financial statements.
b. Disclosure is not an adequate substitute for recognition.
c. Inclusion of employee share options and similar instruments in diluted earnings per share does not constitute recognition of compensation cost.

In light of those conclusions, which were considered in combination with recent events discussed in paragraphs B4–B10, the Board decided that to improve financial reporting it was necessary to require entities to recognize the compensation cost resulting from the consumption of employee services received in exchange for equity instruments.

HOW SHOULD COMPENSATION COST FROM SHARE-BASED COMPENSATION ARRANGEMENTS WITH EMPLOYEES BE MEASURED?

B33. Determining the appropriate measure of compensation cost from share-based compensation arrangements with employees requires resolving two fundamental issues:

a. The date at which the share price (and other pertinent factors) that enter into measurement of the fair value of an award of share-based payment is fixed—the measurement date issue[145]
b. The attribute used to measure the equity instruments awarded, and thus to measure the resulting compensation cost—the measurement attribute issue.

[145]Possible alternative measurement dates do not refer to the date at which accounting for compensation cost begins. For example, most advocates of vesting date measurement would begin accruing compensation cost as soon as employees begin to render the service necessary to earn their awards. Rather, the measurement date issue concerns the date at which the share price and other pertinent factors that enter into the final measure of compensation cost are fixed.

Once those two questions have been resolved, various issues arise about how to apply the measurement basis selected.

Why Grant Date Is the Appropriate Measurement Date

B34. The Board reaffirmed the conclusion reflected in Statement 123 that equity share options and other equity instruments awarded to employees (and subsequently issued to them if vesting conditions are satisfied) and the related compensation cost should be measured based on the share price and other pertinent factors at the date the award is granted. Paragraphs B35–B50 discuss the reasons for that conclusion, including the alternative measurement dates considered.

Alternatives to Grant Date as the Measurement Date

Vesting Date

B35. Proponents of measuring the value of equity instruments awarded to employees and the related compensation cost based on the share price at the date the award vests noted that employees have not earned the right to retain their shares or options until that date. They suggested that a more descriptive term for *grant date* would be *offer date* because the entity makes an offer at that date and becomes obligated to issue equity instruments to employees if the employees render the requisite service or satisfy other conditions for vesting. Employees effectively accept the offer by fulfilling the requisite vesting conditions. Until both parties have fulfilled their obligations under the agreement, the employee has only a conditional right to the equity instruments to be issued. Accordingly, the transaction between the employer and employee should not be fixed until that date—that is, not until the vesting date.

B36. Advocates of vesting date measurement considered it to be consistent with accounting for the issuance of similar equity instruments to third parties for cash or other assets. At the date a share purchase warrant, for example, is issued and measured, the investor receives either the warrant itself or an enforceable right to receive and exercise the warrant without providing additional assets, including services, to the issuer. That is, the rights of the holder of a warrant at the date its fair value is measured and recognized are essentially the same as the rights of an employee at the date an equity share option or similar instrument becomes vested.

Service Date

B37. Unlike most of the other alternatives described, service date measurement does not base the recognition of compensation cost stemming from share-based compensa-

tion arrangements on the share price on a single date. Rather, the share prices on the dates at which employees provide the service necessary to earn their awards are used. Under service date measurement, a proportionate number of the shares subject to a service condition for vesting, for example, would in concept be measured based on the share price each day that an employee renders service. In practice, the results of daily accrual generally could be reasonably approximated by basing the amount of compensation expense recognized each accounting period on the weighted-average share price for that period.

B38. Advocates of service date measurement pointed out that the earning of a share-based compensation award—like the earning of other forms of compensation—is a continuous process. They said that the related compensation cost should be measured based on the share prices during the period the service is rendered—not solely on the share price at either the beginning or the end of that period. In their view, service date measurement is most consistent with the current employee service model based on recognizing and measuring the cost of employee services as the service is rendered.

B39. Vesting date measurement effectively adjusts the value (and related cost) of the service received in, for example, year 1 of a two-year vesting period based on share price changes that occur in year 2. Moreover, the increment (or decrement) in value attributable to year 1's service is recognized in year 2. Advocates of service date measurement contended that to retroactively adjust the value of consideration (in this situation, employee services) already received for future issuance of an equity instrument is to treat awards of equity instruments to employees as if they were liabilities until the employees have vested rights to them. Because an entity that grants share options is obligated only to issue its own shares, not to transfer its assets, advocates of service date measurement contended that measuring nonvested awards as if they were liabilities is inappropriate.

Service Expiration Date

B40. The service expiration date is the date at which all service-related conditions that may change the terms under which employees may exercise their stock options expire. Awards of employee stock options generally specify a limited period of time, often 60 or 90 days, after termination of service during which employees with vested options may exercise them. The options are cancelled if they are not exercised by the end of that period. If the exercise period is 90 days after termination, the service expiration date is 90 days before the maximum term of the options expires. If the options are exercised before then, the exercise date would be the measurement date. For an award of shares

subject to vesting requirements, the service expiration date is the date at which service-related restrictions on the sale of the shares lapse, which usually would be the vesting date.

Component Approaches to Determining the Measurement Date

B41. The Board considered a version of service date and service expiration date measurement in its deliberations that led to the issuance of Statement 123, and respondents to the Exposure Draft of this Statement proposed several other versions of service expiration date measurement. Common to all those versions is the view that a limitation on the period of time an employee may exercise a vested option after termination of service, say to 90 days, effectively reduces the term of the option to 90 days (or whatever the length of the post-termination exercise period).[146] In effect, each day that an employee continues to render service after vesting results in a 1-day extension of the term of the 90-day option. Thus, continued service after vesting is necessary to allow an employee to benefit from the time value of an option with an expected term that is longer than the vesting period. However, because an employee can immediately exercise a vested option and thus benefit from any intrinsic value as soon as the option vests, all versions of service expiration date measurement would call for separating the fair value of an option into its intrinsic value and time value components and recognizing each component differently.

B42. Advocates of those methods also contend that they would be easier to apply than earlier measurement dates. If the period after which service-related conditions expire is short, such as 90 days, concerns about how well traditional option-pricing models measure an option's fair value may be less significant than for a long-term option. Some suggest that use of the market price of a traded option (if the issuing entity has traded options) could be appropriate.

Exercise Date

B43. Under exercise date measurement, the final measure of compensation cost is based on the share price at the date an employee exercises an option (or the date the option lapses or is otherwise settled). Some that favor exercise date measurement do so because they consider call options written by an entity on its shares to be liabilities rather than equity instruments. They acknowledge that neither employee share options

[146]In concept, the post-termination exercise window specified by the terms of an award would be used in applying the service expiration date method. However, to simplify application, proponents of such methods generally suggest using an arbitrary period, usually 90 days, as a proxy for the post-termination exercise window, and this Statement discusses the methods in those terms.

nor share purchase warrants or other call options issued to third parties qualify as liabilities under the definition in Concepts Statement 6 because they do not obligate the entity to transfer its assets to the holder. Those instruments also do not qualify as liabilities under the criteria in FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,* for determining whether an equity-settled obligation embodied in a freestanding financial instrument should be classified as a liability. Those that hold this view generally favor revising the conceptual distinction between liabilities and equity instruments so that an obligation to issue a fixed number of shares at a fixed price would qualify as a liability.

B44. Other advocates of exercise date measurement contend that the intrinsic value, if any, that an employee realizes upon exercise of a share option appropriately measures the amount of compensation paid. They see little, if any, practical difference between an employee share option and a cash bonus indexed to the price of the entity's shares.

B45. From a more pragmatic perspective, advocates note that exercise date measurement is simple and straightforward. The value of a share option upon exercise equals the difference between the exercise price and the market price of the underlying share at that date—its intrinsic value upon exercise. In effect, fair value and intrinsic value are equal at the exercise date. Recognition of compensation cost as an employee provides service before vesting (and recognition of gain or loss as the share price changes after vesting) might be based on the fair value of the option estimated using an option-pricing model. However, the aggregate measure of compensation cost will be the same under exercise date measurement regardless of the measurement method. Concerns about how to apply option-pricing models initially developed for traded options to forfeitable, nontransferable employee options are much less significant if final measurement is based on the intrinsic value, if any, that an employee realizes by exercising an option. The usual accounting response to major problems in measuring the effects of a transaction is to defer final measurement until the measurement difficulties are resolved. Exercise date measurement might be appropriate for that reason regardless of more conceptual considerations.

Conclusion on Measurement Date

B46. As noted in paragraph B34, the Board decided to retain grant date as the measurement date for share-based payment arrangements with employees. By definition, the grant date is the date at which an employer and an employee agree to the terms of a share-based compensation award. The Board concluded that the exchange of equity instruments for employee services should be measured at the date the parties agree to the exchange. In deciding whether and on what terms to exchange equity instruments for employee services, both parties to the agreement presumably base their decisions on

the current fair value of the instrument to be exchanged—not its possible value at a future date. If compensation cost were measured based on the value of the equity instrument at a later date, such as the date at which the award vests, the resulting amount of compensation to be paid or received would not be known when the parties agree to the exchange. In that situation, recognized compensation cost would include both the value of the consideration exchanged for services and the return to the holder of the instrument from subsequent changes in its value.

B47. The Board agreed with the conclusion in Statement 123 that equity instruments subject to service- or performance-based conditions are not issued until the entity has received the consideration for those instruments. However, because the entity becomes contingently obligated at the grant date to issue the instruments granted if employees satisfy the necessary conditions, the employees receive an equity interest in the entity at the grant date. The consideration an employee pays and the employer receives for that equity interest is future employee service. The Board concluded that the value of that service should be measured and recognized based on the share price at the date the parties reach a mutual understanding of the terms of the exchange and the employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares. In addition, a measurement date later than the grant date would result in recognition in the income statement of the effects of changes in the value of an equity interest, which the Board believes is inappropriate.

B48. An overwhelming majority of respondents to both the Invitation to Comment and the Exposure Draft who addressed the issue supported retaining the grant date as the measurement date. In addition to citing reasons similar to those in paragraphs B46 and B47 above, some respondents also pointed out that the compensation cost for employee equity share options and similar instruments that public entities have been either recognizing or disclosing for almost a decade has been based on grant date measurement. Retaining grant date measurement also achieves convergence with international accounting standards on this issue.

Definition of Grant Date

B49. The definition of grant date in this Statement is essentially the same as in Statement 123, which in turn was essentially the same as the notion of grant date used in practice under Opinion 25. Common to all those definitions is the notion of the grant date as the date an agreement or mutual understanding is reached. That is, the grant date is the date at which an employer and employee reach a mutual understanding of (agree to) the key terms and conditions of a share-based payment award. In reconsidering the definition of grant date, however, the Board noted that entities will need to apply that definition to a wide variety of share-based payment awards and that it sometimes may

be difficult to determine when a mutual understanding of the key terms and conditions has been reached. The Board therefore decided to clarify the concepts underlying the definition of grant date by adding the following sentence to the definition in Appendix E:

> The grant date for an award of equity instruments is the date that an employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares.

Some respondents to the Exposure Draft objected to the addition of that sentence. They said that a grant date has been reached when the parties to a share-based payment award have a mutual understanding of how its key terms, for example, the exercise price, will be established, even though the exact terms may not yet be known because they depend solely on a future market price. To illustrate, an award of equity share options may specify that the exercise price will be the market price of the underlying shares on a specified future date.

B50. The Board decided to retain the requirement that the grant date for an award of equity instruments is the date an employee begins to benefit from, or be adversely affected by, changes in the price of the employer's equity shares. Until that date, an employee is not subject to the risks and rewards associated with ownership of an equity instrument.

Why Fair Value Is the Relevant Measurement Attribute

B51. The Board reaffirmed the conclusion in Statement 123 that the fair value of equity instruments, including equity share options granted to employees, is the appropriate basis for measuring the related compensation cost. In reaffirming that conclusion, the Board considered the same alternatives to fair value that were discussed in Statement 123.

Alternatives to Fair Value as the Measurement Attribute

Intrinsic Value

B52. The intrinsic value of an option is the difference between its exercise price and the current price of the underlying share. Intrinsic value thus excludes the value of the right to purchase the underlying share at a fixed price for a specified future period—its time value. Respondents that favored measuring employee share options at their intrinsic value generally said that intrinsic value is easily measured and understood. Some also noted that employees cannot convert the time value of their options to cash.

B53. Intrinsic value measurement might be combined with any of the measurement dates discussed in paragraphs B35–B50. However, the vast majority of the advocates of intrinsic value would only accept intrinsic value measurement at the grant date. They generally asserted that the recognition requirements of Opinion 25, coupled with the pro forma disclosure requirements of Statement 123, had provided users of financial statements with adequate information.

Minimum Value

B54. The minimum value method derives its name from the theory underlying its calculation. The idea is that an investor who wishes to purchase a call option on a given share would be willing to pay *at least* (perhaps more important, the option writer would demand *at least*) an amount that represents the benefit (sacrifice) of the right to defer payment of the exercise price until the end of the option's term. For a dividend-paying share, that amount is reduced by the present value of the expected dividends during the time the option is outstanding because the holder of an option does not receive the dividends paid on the underlying share.

B55. Thus, the minimum value method reflects one part of the time value of an option—the value of the right to defer payment of the exercise price until the end of the option's term. But minimum value ignores what for many options is likely to be a greater part of time value—the right to benefit from increases in the price of the underlying share without being exposed to losses beyond the premium paid (sometimes termed *volatility value*). Advocates of minimum value generally contended that it would be too difficult to measure the volatility value component of time value (and thus of fair value) and that the resulting estimates of fair value would be too subjective for recognition in the financial statements. They noted that basing the measure of share options and similar instruments on a volatility of zero would produce a more objective measure than use of what they consider to be a subjective and difficult-to-audit expected volatility, which is needed to estimate fair value.

Conclusion on Measurement Attribute

B56. In reaffirming the conclusion in Statement 123 that equity instruments, including share options and similar instruments, awarded to employees as compensation should be measured at fair value, the Board noted that share options and other instruments that have time value are routinely traded in the marketplace at prices that are based on fair value—not on intrinsic value or minimum value. Consistent with that fact, other equity instruments and the consideration the issuing entity receives in exchange for them are recognized based on their fair values at the date the instruments are issued. For example, the initial recognition of debt issued with detachable share purchase warrants

is based on the relative fair values of the debt and the warrants at the date of issuance—not on either the intrinsic value or the minimum value of the warrants. Similarly, an equity share or an equity share option issued in exchange for an asset other than employee services, such as a piece of equipment or legal services, and the related cost would be measured at either the fair value of the asset received or the fair value of the equity instrument issued, whichever is more reliably measurable. The Board sees no reason to measure compensation paid in equity share options or other equity instruments on a different basis. The Board concluded that it would not be feasible to measure directly the fair value of employee services received in exchange for employee share options or other equity instruments. Employee services generally are measured and accounted for based on the amount of consideration paid for them, regardless of the nature of the consideration. Thus, this Statement requires that the compensation cost for employee services received in exchange for equity instruments be based on the fair value of the instruments issued.

B57. Various valuation techniques are available for estimating the fair value of employee share options. Virtually any option-pricing model that is consistent with the fair value measurement objective and is applied in accordance with the guidance for its application discussed in paragraphs A2–A17 will result in an estimate of fair value that will be a more representationally faithful basis for recognition of compensation cost than either the intrinsic value or the minimum value of the options at the grant date. The grant-date intrinsic value method in Opinion 25 omits most of the factors that make an option valuable. Thus, it understates the value at the grant date of even those options for which Opinion 25's method does result in recognition of compensation cost. That is, the grant-date intrinsic value of an option fails to reflect the value of the holder's ability to benefit from increases in the price of the underlying share without being exposed to losses beyond the amount of the premium paid for the option. Minimum value reflects some, but not all, of the key factors that give a share option value. Moreover, Opinion 25's intrinsic value method often results in a higher (and more volatile) measure of compensation cost for a variable award, such as one with a market condition, than for an award that is similar except for the market condition, even though the presence of the condition reduces the value of the award.

B58. Even though measures of the grant-date intrinsic value of share options made by different entities presumably were comparable, the resulting financial statements were not necessarily comparable. For example, assume that in 2005 Entity A grants 500,000 share options with a total fair value of $1.5 million and an intrinsic value of zero. In the same year, Entity B, which is in the same industry, grants only 50,000 options with a fair value of $200,000 and an intrinsic value of zero. If the compensation cost for

employee share options is recognized based on their intrinsic value at grant date, compensation cost reported by Entity A is understated by $1.5 million, while Entity B's is understated by only $200,000.

Is the Fair Value of Employee Share Options Measurable with Sufficient Reliability for Recognition in Financial Statements?

B59. Many respondents to the Exposure Draft and others who did not consider required recognition of compensation cost for employee services received in exchange for equity share options and similar instruments to be appropriate cited reliability concerns. Critics generally asserted that available valuation techniques, especially the Black-Scholes-Merton option-pricing formula and similar closed-form models, do not adequately take account of unique features of employee share options. They also pointed out that closed-form models may not be the best way to estimate the fair values of long-term options, even those without the unique features of employee share options, because those models are limited to single weighted-average assumptions for expected volatility and expected dividends. Some recommended deferring required recognition of compensation cost from employee share options until a better valuation technique for those instruments is developed. They contended that recognizing compensation cost based on fair value estimated using currently available valuation techniques would add an unacceptable level of measurement error to financial statements and impair their reliability and comparability.

B60. The Board did not find those assertions persuasive. During the course of its work on share-based payment, the Board and its staff devoted thousands of hours to understanding the available valuation models and how they can be applied to estimate the fair value of employee share options and similar instruments. That work encompassed discussions with many valuation experts, including those who developed some of the most widely used and familiar models. Based on that work, the Board concluded that entities can develop estimates of the fair value of equity instruments, including equity share options, awarded to employees that are sufficiently reliable for recognition in financial statements. The Board therefore concluded that use of the fair-value-based method required by this Statement will improve not only the relevance and reliability, but also the credibility, of financial statements. Without estimates, accrual accounting would not be possible. For example, financial statement amounts for loan loss reserves, valuation allowances for deferred tax assets, and pensions and other postretirement benefit obligations are based on estimates. For those and many other items in accounting that necessitate the use of estimates, companies are required to use appropriate measurement techniques, relevant data, and management judgment in the

preparation of financial statements.[147] Few accrual-based accounting measurements can claim absolute reliability, but most parties agree that financial statement recognition of estimated amounts is preferable to the alternative—cash basis accounting.

Guidance on Estimating Fair Value

B61. Having concluded that fair value is the appropriate measurement attribute for measuring the value of the services received in exchange for equity instruments issued to employees and the related compensation cost, the Board considered what guidance to provide on estimating fair value.

General Guidance on Estimating Fair Value

B62. This Statement significantly enhances and clarifies Statement 123's guidance on estimating the fair value of equity share options and other equity instruments granted to employees. The FASB's Option Valuation Group (paragraph C20), as well as other valuation experts, provided valuable assistance in developing the revised guidance. This Statement requires that the fair value of an employee share option be based on an observable market price of an option with the same or similar terms and conditions if one is available. Although such market prices are not currently available, that requirement, together with the guidance in paragraphs A2–A42 of this Statement, clearly establishes the objective of the estimation process when fair value is estimated using a valuation technique. Moreover, market prices for equity share options with conditions similar to those in certain employee options may become available in the future.

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[147] U.S. generally accepted accounting principles and generally accepted auditing standards currently address many circumstances in which entities use estimates. For example, APB Opinion No. 20, *Accounting Changes,* requires disclosure about changes in estimates. AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties,* requires general disclosure in the notes to financial statements that the preparation of financial statements requires the use of estimates. AICPA Auditing Standards AU Section 380, "Communication with Audit Committees," addresses communicating certain estimates to the audit committee. In addition, the SEC has provided cautionary advice about public companies' disclosure of critical accounting policies used in financial statements (Cautionary Advice Regarding Disclosure about Critical Accounting Policies, Releases No. 33-8040, 34-45149; FR-60 [December 12, 2001]). Those required disclosures identify methods, estimates, and judgments that companies use in applying those accounting policies that have a significant impact on the results reported.

Estimating the Fair Value of Employee Share Options Using a Valuation Technique Such as an Option-Pricing Model

B63. This Statement, as did Statement 123, provides more guidance on how to estimate fair value than other recently issued accounting standards generally provide. For example, FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* which requires derivative instruments, including options, to be measured at fair value, defines fair value but does not provide further guidance on how to apply valuation techniques if a market price is not available.[148] The Board noted that observable market prices rarely, if ever, will be available—either when the instrument is granted or subsequently—for some instruments, such as employee share options, to which this Statement applies. In contrast, observable market prices often will be available for many of the instruments to which Statement 133 applies. In addition, Statement 133 generally is applied in a highly developed and sophisticated market environment, while this Statement will be applied broadly by entities with widely varying degrees of experience in estimating fair values. Numerous respondents to the Invitation to Comment asked the Board to revise, elaborate on, or clarify the guidance in Statement 123 on estimating the fair value of employee share options. The Board therefore concluded that providing guidance on estimating the fair value of employee share options continues to be appropriate. Respondents to the Exposure Draft generally agreed with the level of guidance provided for estimating the fair value of instruments granted to employees as compensation, although some respondents disagreed with certain aspects of that guidance or asked for additional guidance on estimating fair value.

Nature of the Option-Pricing Model Used

B64. As discussed in paragraphs A10–A17, closed-form models are one acceptable technique for estimating the fair value of employee share options. However, a lattice model (or other valuation technique, such as a Monte Carlo simulation technique, that is not based on a closed-form equation) can accommodate the term structures of risk-free interest rates and expected volatility, as well as expected changes in dividends over an option's contractual term. A lattice model also can accommodate estimates of employees' option exercise patterns and post-vesting employment termination during the option's contractual term, and thereby can more fully reflect the effect of those

[148]In June 2004, the Board issued for comment an Exposure Draft, *Fair Value Measurements*. Except for the factors explicitly excluded from this Statement's fair-value-based measure (for example, refer to the items noted in paragraphs 18–20, 26, and 27 of this Statement), the guidance on estimating fair value in Appendix A of this Statement is consistent with, but more expansive than, the guidance that the Exposure Draft would establish.

factors than can an estimate developed using a closed-form model and a single weighted-average expected life of the options.

B65. For the reasons discussed in paragraph B64, the Exposure Draft would have established a lattice model as preferable for purposes of justifying a change in accounting principle. Once an entity had adopted that valuation technique, it would have been prohibited from changing to a less preferable technique. Many of the respondents to the Exposure Draft who addressed the issue objected to establishing a lattice model as preferable and said that the guidance in the Exposure Draft would have been interpreted as effectively requiring most public entities to use a lattice model once the necessary data were available. Some of those respondents noted that other valuation techniques, such as a Monte Carlo simulation technique, also generally would provide estimates of fair value that are superior to those resulting from use of a closed-form model, such as the Black-Scholes-Merton formula. Some respondents said that establishing a lattice model as preferable might inhibit future development of better models for estimating the fair value of employee share options.

B66. In light of the comments on the Exposure Draft, the Board decided not to establish a lattice model as preferable. The Board concluded that the objective of fair value measurements in paragraph A7, together with the discussion in paragraphs A8–A17, of how that objective might be achieved, is sufficient to help entities select a valuation technique that best fits their circumstances. Thus, the guidance in Appendix A of this Statement has been revised to remove the preferability of a lattice model and to clarify that neither a lattice model nor any other specific model is required.

B67. Valuation techniques for financial instruments, including employee share options, continue to evolve. Required recognition of compensation cost based on the fair value of employee share options may lead to the development of improved commercially available valuation techniques for those instruments.

B68. This Statement improves the guidance in Statement 123 on how to use an option-pricing model in estimating the fair value of an equity share option or similar instrument, including how to select the necessary assumptions. The FASB's Option Valuation Group, as well as other valuation experts, provided extensive help in developing those improvements. Paragraphs B63–B101 explain the Board's basis for its conclusions on applying an option-pricing-model or other valuation technique in estimating the fair value of employee share options.

Conditions and Restrictions That Apply Only during the Requisite Service Period

B69. This Statement retains the modified grant date method established in Statement 123, under which no compensation cost is recognized for awards for which the requisite service is not rendered. Respondents to both the Invitation to Comment and the Exposure Draft generally supported retaining that method.

B70. Investors who purchased equity instruments with restrictions similar to those in a nonvested award of employee share-based compensation (including both nonvested share options and nonvested shares) would take those restrictions into account in considering how much they would be willing to pay for the instruments. That is, a market price, if one existed, would reflect all restrictions inherent in the instrument, including restrictions that stem entirely from the forfeitability of the instruments if vesting conditions are not satisfied. Thus, a *pure* (as opposed to *modified*) grant date measure of fair value also would reflect all restrictions inherent in an award of share-based employee compensation, including vesting conditions and other restrictions that expire upon vesting. The recognized amount of compensation cost would not be subsequently adjusted to reflect the outcome of those conditions and other restrictions. The Board concluded, however, that in the absence of an observable market price for nonvested equity instruments similar to those awarded to employees, the effects of vesting conditions on fair value at the grant date are not measurable with sufficient reliability to serve as the final measure of compensation cost. Therefore, the Board decided to retain the modified grant date method required by Statement 123 under which the outcomes of all vesting conditions and other factors that apply only during the requisite service period are reflected in the ultimate measure of compensation cost.

B71. In addition, the Board noted that nonvested share-based employee compensation does not give rise to an asset at the grant date because the employer cannot require employees to render the requisite service or satisfy any other conditions necessary to earn their nonvested awards. Thus, at the grant date (or the service inception date), the employer does not yet control probable future economic benefits—in this case, employee services. That is in contrast to prepaid fees for legal services, consulting services, insurance services, and the like, which represent probable future economic benefits that are controlled by the entity because the other party to the transaction has entered into a contract to provide services to earn the fees. Unlike an employee with a nonvested award, the service provider is not entitled to walk away from its obligation to render the services that are the subject of the contract by merely foregoing collection of the fee for services not rendered.

B72. For the reason discussed in paragraph B71, this Statement does not require recognition of prepaid compensation (or any other asset) at the grant date. An investor who is not an employee transfers cash or other assets, such as an enforceable obligation to pay cash, for an equity instrument at the date it is issued. Thus, “pure” grant date accounting might be viewed as appropriate only if the employer obtained an asset at the grant date, such as prepaid compensation, representing an enforceable right to receive employee services in the future. It also might be argued that the inappropriateness of recognizing prepaid compensation (that is, the fact that nonvested instruments have not yet been issued) supports vesting date accounting. However, the Board concluded for the reasons discussed in paragraphs B46–B48 that measurement based on the share price and other pertinent factors at the grant date is appropriate.

Inability to Transfer Employee Share Options to Third Parties and Other Restrictions That Continue after Vesting

B73. Equity instruments awarded to employees may carry restrictions that continue in effect after vesting. Under the modified grant-date method required by this Statement, the measurement objective is to estimate the fair value of the equity instruments to which employees become entitled when they have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments. Consistent with that objective, the effect of restrictions that continue after an employee has a vested right to an instrument are reflected in estimating the fair value of the instrument at the grant date.

B74. Certain post-vesting restrictions, such as a contractual prohibition on selling shares for a specified period of time after vesting, are essentially the same as restrictions that may be present in equity instruments exchanged in the marketplace. For those restrictions, either a market price of a similar traded instrument or, if one is not available, the same valuation techniques used to estimate the fair value of a traded instrument are to be used to estimate the fair value of a similar instrument awarded to employees as compensation. However, the most common restriction embodied in equity instruments awarded to employees, the inability to transfer a vested share option to a third party, rarely, if ever, is present in traded share options.

B75. The value of a transferable option is based on its contractual term because it rarely is economically advantageous to exercise, rather than sell, a transferable option before the end of its contractual term. Employee share options differ from most other options in that employees cannot sell their options to third parties—they can only exercise them. The effect of that restriction is to increase the likelihood that an employee share option will be exercised before the end of its contractual term because exercise is the only available means to terminate the holder’s exposure to future

changes in the price of the underlying share. (Also refer to the discussion in paragraphs B80–B82 related to employees' inability to hedge their options.) Thus, this Statement requires that the value of a nontransferable employee share option be based on its expected term rather than its contractual term.

B76. Members of the Option Valuation Group, as well as many respondents to the Exposure Draft, agreed that the appropriate method of reflecting employees' inability to transfer their options to third parties is to base the estimate of fair value on the expected term of the options. However, some commentators suggested valuing a nontransferable option based on its contractual term and then reducing that amount by a percentage that is considered to reflect the discount that market participants would apply in determining an exchange price for a nontransferable option. A discount of as much as 50 percent was suggested. Commentators who favored that method said that it would provide a better estimate of the fair value of a nontransferable option and also would eliminate the need to estimate employees' expected exercise and post-vesting employment termination behavior. They asserted that many entities did not have the necessary information on which to base such estimates and that the estimates thus would be overly subjective as well as costly to develop.

B77. The Board carefully evaluated an alternative method of estimating the fair value of employee share options proposed by a group of constituents that would have used a percentage discount to reflect the effect of nontransferability. The Board and its staff discussed that proposed alternative method with members of the Option Valuation Group and other valuation experts, in addition to reviewing the results of pertinent academic research. Those discussions and review supported the Board's conclusion that the effect of the nontransferability of an employee share option is to make it likely that the option will be exercised before the end of its contractual term. Thus, estimating the option's fair value based on its expected term directly reflects the behavioral effect of nontransferability. The Board understands that use of the expected term may in some situations result in an estimated fair value that is as much as 50 percent lower than the fair value of an otherwise identical transferable option. Based on its discussions with valuation experts, together with its review of the relevant academic literature, the Board believes that marketplace participants would likely base their estimate of the appropriate percent discount for a nontransferable option on the difference between fair value estimated using the option's expected term and the value estimated using contractual term. In other words, incorporating employees' expected early exercise and post-vesting employment termination behavior in estimating the fair value of nontransferable options is the same process that would need to be applied to determine an appropriate percentage discount. The Board concluded that requiring entities to apply the process needed to determine an appropriate percentage discount would produce a

more representationally faithful result than would an approach that presumes what the outcome of the process (the resulting percentage discount) would be.

B78. The Board also concluded that applying a similar percentage discount to determine the fair value of options with a variety of terms and conditions would be unlikely to faithfully represent the effects of nontransferability on each of those options. The result would be false comparability in which unlike things are made to look the same.

B79. Statement 123 required the same method of reflecting the effect on fair value of employees' inability to transfer their vested options to third parties that this Statement requires. However, in describing the expected term of an option, Statement 123 used the term *expected life,* and the related guidance focused primarily on estimating the weighted-average period of time employee share options were expected to remain outstanding. This Statement refers to the *expected term* of an option, which is based on the option's contractual term and employees' expected early exercise and post-vesting employment termination behavior. The valuation guidance and illustrations in Appendix A of this Statement discuss how expectations about those behaviors can be related to the intrinsic value of the option, among other factors. In using a lattice model, an option's expected term may be inferred based on the output of the model, but expected term is not a direct input to that model. Paragraph 282 of Statement 123 explained that method and indicated that entities might wish to use it.

Employees' Inability to Hedge Call Option Positions

B80. Federal securities law precludes certain executives from selling shares of the issuer's stock that they do not own, and the Board understands that many public entities have established share trading policies that effectively extend that prohibition to other employees.

B81. Some respondents who did not consider requiring the fair-value-based method of accounting for employee share options to be appropriate noted that the theory underlying both closed-form and lattice option-pricing models involves replicating an option position with an offsetting position in the underlying security. Those opponents said that the inability of most employees to sell shares of their employer's stock that they do not own (to "short" the stock) calls for an additional (downward) adjustment to the fair value of a nontransferable option estimated using an option-pricing model. One method of determining that adjustment suggested by certain respondents to the Exposure Draft would discount the output of an option-pricing model by a rate that includes the employer's equity risk premium to reflect the presumably higher return required by an investor in an option that cannot be hedged.

B82. In addition to reviewing the relevant academic research, the Board discussed with experts in option valuation, including members of the Option Valuation Group, the effect of employees' inability to hedge their options positions on the fair value of employee options and its relationship to the inability to transfer vested options. Those experts agreed that nonhedgability and nontransferability have the same effect on option value because both factors increase the likelihood that an employee share option will be exercised before the end of its contractual term. Thus, using the expected term rather than the contractual term of the option in estimating its fair value reflects the effects of both factors.

Effect of Potential Dilution on the Fair Value of Employee Share Options

B83. Some respondents to the Exposure Draft said that the effect of the potential dilution of the value of the underlying shares resulting from option exercise should be taken into account in estimating the fair value of all employee equity share options. Paragraph A38 explains why the exercise of an employee share option has the potential to dilute (decrease) the value of the underlying shares and thus decrease the employee's gain from exercising the option. Paragraph A39 then notes that the effect of potential dilution usually is already reflected in the market price of a public entity's shares and that applying a separate discount for dilution rarely will be appropriate. For example, assume that the total market value of Entity D's 1 million common shares outstanding is $10 million on the date that it grants employee share options on 10,000 shares. If marketplace participants have anticipated that grant based on Entity D's past practice or other available information, the market price of $10 per share already reflects the market's assessment of the dilutive effect of that grant. Assuming that the market does not expect an offsetting increase in Entity D's share price as a result of the grant (and the only expected effect thus is dilution), the share price without the anticipated grant of 10,000 share options might be higher. Thus, the $10 share price used in estimating the fair value of the options already reflects the effect of potential dilution, and to include a separate discount for dilution would double count its effect.

B84. The Board's understanding of the effect of potential dilution on the fair value of an employee share option was based on and confirmed by discussion with members of the Option Valuation Group and other valuation experts. Thus, paragraph A40 of this Statement provides that an entity should consider whether the potential dilutive effect of an award of share options needs to be separately reflected in estimating the options' fair value at the grant date but notes that rarely will a public entity need to do so. In addition, the applicability of a separate adjustment for dilution in estimating the fair value of a nonpublic entity's share options may depend on how the fair value of its shares is determined.

Other Assumptions Needed to Estimate the Fair Value of Employee Share Options

B85. Paragraphs A31–A37 provide guidance on two additional assumptions needed to estimate the fair value of an employee share option using an option-pricing model—expected volatility of, and expected dividends on, the underlying shares. Paragraphs B86–B93 discuss that guidance, including comments by respondents to the Exposure Draft.

Expected Volatility

B86. This Statement does not specify a method of estimating expected volatility; rather, paragraph A32 provides a list of factors to be considered in estimating expected volatility. In addition, paragraph A21 indicates that an entity might decide that historical volatility is a reasonable indicator of expected volatility but that the entity should consider ways in which future volatility is likely to differ from historical volatility. As with other aspects of estimating fair value, the objective is to determine the assumption about expected volatility that marketplace participants would be likely to use in determining an exchange price for an option.

B87. A majority of respondents to the Exposure Draft who discussed specific measurement issues supported a flexible approach to estimating expected volatility based on an indication of factors to be considered rather than a more inflexible approach that would specify a single method of determining expected volatility. Many respondents noted that such a flexible approach is consistent with a principles-based approach to standard setting. However, some respondents suggested that the Board either require or permit entities to use some form of standardized volatility assumption. For example, certain respondents suggested providing that historical volatility could be considered a "safe harbor" in all situations. Other respondents suggested use of the historical volatility of an index—either unadjusted or adjusted by the beta[149] of an entity's share price. Those suggestions were based on the view that even publicly traded entities cannot be expected to apply guidance such as that provided in paragraph A32 to develop reasonable estimates of the expected volatility of their share price. The Board rejected that view—the Board believes that public entities will be able to exercise appropriate judgment in estimating expected volatility, just as they do in other areas of accounting that require relatively high levels of management judgment. Establishing a single method for all entities to use in determining expected volatility would inevitably impair the representational faithfulness of the resulting information.

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[149]Beta is a measure of the volatility of a share relative to the overall volatility of the market. A beta of one is assigned to the volatility of the overall market. Thus, a beta of less than one indicates lower risk than the market; a beta of more than one indicates higher risk than the market.

For example, although use of unadjusted historical volatility may be appropriate for some entities (or even for most entities in some time periods), a marketplace participant would not use historical volatility without considering the extent to which the future is likely to differ from the past.

B88. The Board also is unaware of situations in which marketplace participants would base an estimate of the fair value of a share option either on the volatility of an index or on an index volatility adjusted by an entity's beta. Beta is not a measure of the volatility of an individual entity's shares; rather, an entity's beta is determined by comparing its volatility with the volatility of an index that represents the overall market. That measure does not reflect the unique risk inherent in an individual entity's share price because share price movements are not perfectly correlated with movements in the index. Accordingly, the suggested procedure of adjusting the volatility of an index by an entity's beta would not result in an appropriate surrogate for expected volatility.

B89. The Board also notes that public entities in the United States have for the past decade been required to estimate the expected volatility of their share price for either recognition or pro forma disclosures under Statement 123, and over 3,600 public entities in Canada are subject to similar requirements. Respondents to the Exposure Draft suggested additional factors that might be helpful in estimating expected volatility, such as the implied volatility of outstanding convertible debt, if any. The Board agreed with those suggestions. The Board concluded that entities should be able to use the improved guidance in Appendix A and build on their experience in developing estimates of expected volatility to appropriately comply with the requirements of this Statement.

Expected Dividends and Dividend Protection

B90. Paragraphs A35–A37 provide guidance on estimating expected dividends on the underlying shares for use in an option-pricing model. As with other aspects of estimating fair value, the objective is to determine the assumption about expected dividends that would likely be used by marketplace participants in determining an exchange price for the option.

B91. Some employee share options are dividend protected. Dividend protection may take a variety of forms. For example, the exercise price of the option may be adjusted downward during the term of the option to take account of dividends paid on the underlying shares that the option holder does not receive. Alternatively, the option holder may receive the dividends or dividend equivalent payments in cash. The Exposure Draft would have carried forward Statement 123's requirement that either form of dividend protection be reflected by using an expected dividend assumption of

zero in using an option-pricing model to estimate fair value. One respondent pointed out that different forms of dividend protection may have different effects on the fair value of the related option. For instance, whether the option holder receives a cash payment during the option term or the exercise price is reduced affects a dividend-protected option's fair value. The Board agreed. The Board also noted that it is not feasible to anticipate all means by which an option holder may be provided full or partial dividend protection. Accordingly, this Statement requires that dividend protection be appropriately reflected in estimating the fair value of a dividend-protected option rather than specifying a single method of doing so.

B92. This Statement carries forward Statement 123's requirements on the treatment of nonrefundable dividends paid on shares of nonvested stock that the entity estimates will not, and that do not, vest. Those dividends are recognized as additional compensation cost during the vesting period. If an employee terminates service and forfeits nonvested stock but is not required to return dividends paid on the stock during the vesting period, the Board concluded that recognizing those dividends as compensation is appropriate.

B93. The fair value of a share of stock in concept equals the present value of the expected future cash flows to the stockholder, which includes dividends. Therefore, additional compensation does not arise from dividends on nonvested shares that eventually vest. Because the measure of compensation cost for those shares is their fair value at the grant date, recognizing dividends on nonvested shares as additional compensation would effectively double count those dividends. For the same reason, if employees do not receive dividends declared on the class of shares granted to them until the shares vest, the grant-date fair value of the award is measured by reducing the share price at that date by the present value of the dividends expected to be paid on the shares during the requisite service period, discounted at the appropriate risk-free interest rate.

Measurement of Equity Share Options Granted by a Nonpublic Entity

B94. Statement 123 permitted a nonpublic company to omit expected volatility (or to use an expected volatility of effectively zero) in estimating the value of its equity share options granted to employees. The result was a measure termed *minimum value*. The Board said in Statement 123 that, in concept, options granted by a nonpublic entity should be measured at fair value—the use of minimum value was only a practical response to the difficulties of estimating the expected volatility for a nonpublic entity.

B95. The Exposure Draft would have eliminated the minimum value method and required a nonpublic entity to make a policy choice of whether to measure its share options at their fair value at the grant date or at their intrinsic value through the date the

options were exercised, lapsed, or otherwise settled. Many respondents to the Exposure Draft objected to that proposed requirement. Some said that it was not appropriate for a nonpublic entity to have a choice of accounting methods unless the same choice also was available to public entities. That is, those respondents objected to providing separate accounting methods for nonpublic and public entities because they think that the same transactions should be accounted for similarly by all entities regardless of their status as public or nonpublic. Other respondents said that both methods of accounting for options granted by a nonpublic entity would be unduly burdensome. In particular, respondents objected to the intrinsic value method because it would require estimates of the fair value of the entity's shares at each reporting date—estimates that for some nonpublic entities would not be required for any other purpose and that could be costly to obtain.

B96. The Board agrees with respondents who said that two entities should not use different methods to measure and account for their equity share options solely because one is public and the other is not, that is, that the basic measurement method should not be the subject of a policy choice. Therefore, the Board concluded that the fair-value-based measurement requirement should be the same for public entities and nonpublic entities. However, the Board recognizes that a nonpublic entity may have difficulty estimating the expected volatility of its share price because of the lack of frequent observations of the fair value of its shares. Accordingly, if it is not possible for a nonpublic entity to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for the entity to estimate the expected volatility of its share price, this Statement requires that the entity measure its equity share options and similar instruments at a value calculated by substituting the historical volatility of an appropriate industry sector index for expected volatility in applying an option-pricing model. Illustration 11(b) in Appendix A provides guidance on the circumstances in which a nonpublic entity should use the historical volatility of an industry sector index and how to select an appropriate index.

B97. Although the Board concluded that the fundamental measurement requirements for equity share options should be the same for both public and nonpublic entities, the Board was persuaded by comments received on the Exposure Draft and the Invitation to Comment, as well as the additional cost-benefit procedures undertaken for nonpublic entities after the comment period on the Exposure Draft (paragraph B278), that a limited practicability exception is appropriate. The Board believes the requirements for nonpublic entities in this Statement will minimize the measurement differences between public and nonpublic entities without imposing an undue burden on nonpublic entities.

B98. The Board understands that relatively few small nonpublic entities offer share options to their employees, and those that do often are emerging entities that intend to make a future initial public offering. Many of those nonpublic entities that plan an initial public offering likely will be able to reasonably estimate the fair value of their equity share options and similar instruments using the guidance on selecting an appropriate expected volatility assumption provided in Appendix A. For those nonpublic entities for which it is not practicable to estimate expected volatility, the alternative measure in this Statement will impose minimal incremental cost over the minimum value method required by Statement 123, which required all of the same assumptions except for expected volatility. Determining the historical volatility of an appropriate industry sector index required for use in the calculated value alternative is a mechanical process that should not be difficult or costly to implement once the appropriate index is identified. In addition, because the calculated value does not omit expected volatility entirely, it should be a better surrogate for fair value than either the minimum value method in Statement 123 or the intrinsic value alternative proposed in the Exposure Draft.

B99. In deciding to require fair value as the measurement method for equity share options of nonpublic entities with a limited practicability exception, the Board acknowledged that estimating the expected volatility of a nonpublic entity's shares may be difficult and that the resulting estimated fair value may be more subjective than the estimated fair value of a public entity's options. However, the Board agrees with members of the Option Valuation Group that many nonpublic entities could consider internal and industry factors likely to affect volatility, and the average volatility of comparable entities, to develop an estimate of expected volatility. Using an expected volatility estimate determined in that manner often would result in a reasonable estimate of fair value.

B100. Some constituents questioned why the Board did not attempt to develop an alternative means for a nonpublic entity to reflect other factors, such as expected term, used in estimating the fair value of employee share options. The Board focused on expected volatility because it concluded that volatility is the only area in which a nonpublic entity is likely to encounter difficulties that are directly and uniquely related to its nonpublic status. In addition, to comply with the minimum value requirements of Statement 123, nonpublic entities were required to estimate other factors needed to estimate fair value or calculated value, such as the expected term of equity share options. Accordingly, the Board concluded that it would not be appropriate to provide a practicability exception for those assumptions.

B101. Some respondents suggested that any alternative measurement approach permitted for nonpublic entities also should apply to newly public entities. For much the

same reasons cited in paragraph B99 for the Board's conclusion that many nonpublic entities should be able to reasonably estimate fair value, the Board decided not to extend the calculated value method to newly public entities. Once an entity "goes public," it should be able to identify comparable public entities and use the average volatility of those entities together with other internal and external data to develop a reasonable estimate of its expected volatility. Moreover, extending the practicability exception to newly public entities would require a definition of *newly public entity* because it is necessary to identify some point at which an entity no longer qualifies to use calculated value rather than fair value. The Board concluded that a logical and workable point is when an entity becomes a public entity—a term for which a longstanding definition in share-based payment accounting guidance is available (refer to Appendix E).

What If It Is Not Possible to Reasonably Estimate the Fair Value of an Equity Instrument at the Grant Date?

B102. Statement 123 provided that if it is not possible to reasonably estimate the fair value of an equity share option or similar equity instrument at the grant date, the final measure of compensation cost would be fair value estimated based on the share price and other factors at the first date at which reasonable estimation is possible. Paragraph 25 of this Statement instead requires that such an instrument continue to be measured at its intrinsic value at each reporting date until it is exercised or otherwise settled.

B103. In light of the variety of options and option-like instruments currently trading in external markets and the advances in methods of estimating their fair values, the Board expects that few instruments presently awarded to employees by public entities will fall into the category of instruments for which it is not possible to reasonably estimate fair value (or calculated value, for a nonpublic entity that qualifies to use that measure) at the grant date. For those that may, the Board is not aware of instances in which estimating fair value (or calculated value) at a date between grant and settlement will be significantly easier than estimating fair value at the grant date. In addition, the Board is concerned that continuing to permit the final measure of compensation cost to be based on the estimated fair value at the earliest date at which an entity decides such estimation is feasible might have unintended consequences. Requiring an entity to make a decision about whether it is possible to reasonably estimate fair value at the grant date and to follow the corresponding accounting treatment until settlement is more straightforward than Statement 123's original requirement. Therefore, the Board decided to require remeasurement of intrinsic value at each reporting date until settlement, even if the entity later concludes that it would be possible to reasonably estimate fair value (or calculated value) before the settlement date.

Reload Options

B104. Reload options are granted upon exercise of previously granted options whose original terms provide for the use of shares that the employee has held for a specified period of time, referred to as *mature shares,* rather than cash to satisfy the exercise price. At the time of exercise using mature shares, the employee is automatically granted a reload option for the same number of shares used to exercise the original option. The exercise price of the reload option often is the market price of the stock at the date the reload option is granted, and its term often is equal to the remainder of the term of the original options.

B105. Some respondents to the Exposure Draft, as well as some respondents to the Exposure Draft that preceded Statement 123, suggested that an option with a reload feature can be valued at the grant date as a "forward start option" commencing at the date or dates that the option is "reloaded." The forward start option's value would be added to the value of the option granted with a reload feature to determine the total value of the award. However, the forward start option formula calls for a number of subjective assumptions, such as the number of expected reloads and the expected timing of each reload. In addition, because an employee can take advantage of the reload feature only with shares already held, the employer would need to estimate (a) the number of employees who are expected to pay the exercise price with those shares rather than with cash and (b) those employees' holdings of mature shares.

B106. Because a reload feature is part of the options initially awarded, the Board believes that the value added to those options by the reload feature ideally should be considered in estimating the fair value of the initial award at its grant date. However, the Board concluded that it is not feasible to do so at this time. Accordingly, the Board concluded that the best way to account for an option with a reload feature is to treat both the initial grant and each subsequent grant of a reload option as separate awards.

TRANSFERS OF SHARE-BASED PAYMENT TO EMPLOYEES BY ECONOMIC INTEREST HOLDERS

B107. Statement 123 required that an entity recognize compensation cost for equity instruments granted or otherwise transferred to an employee by a *principal shareholder* of the entity unless the transfer clearly was for a purpose other than compensation.[150]

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[150]An example of a situation in which a direct transfer of equity instruments to an employee from a principal shareholder (or other related party or economic interest holder) is not compensation cost is a transfer to settle an obligation of the principal shareholder unrelated to employment by the reporting entity.

The Board concluded at that time that the substance of such a transaction is that the principal shareholder makes a capital contribution to the entity, which the entity uses to grant share-based compensation to the employee who receives the equity instruments. Paragraph 395 of Statement 123 defined a principal shareholder as:

> 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.

B108. ED2 contained a similar provision, except that a direct transfer of equity instruments from any shareholder, not only a principal shareholder, to an employee as payment for services received by the reporting entity was to be recognized as share-based compensation. Most respondents to the Invitation to Comment and to ED2 who addressed this issue supported ED2's proposed requirement (which is in IFRS 2).

B109. The Board agreed that the scope of Statement 123's requirements for such transfers should be expanded to encompass transfers from any shareholder. However, the Board saw no reason to limit the provision to transfers by shareholders. Holders of other forms of economic interests in an entity, such as holders of convertible debt or other creditors, might see the likelihood of sufficient indirect benefit to themselves to justify compensating one or more of the employees of a reporting entity by transferring to those employees share-based payment of that entity.

B110. The Board intends the provision in paragraph 11 of this Statement to be applied by analyzing transactions in which a related party or a holder of an economic interest in the reporting entity transfers (or offers to transfer) share-based payment of the entity to an employee of the entity to determine whether the entity benefits from the transfer. If so, the transfer should be accounted for as share-based compensation to the employee and a capital contribution received from the transferring party. In broadening that requirement, the Board noted its belief that such a transfer is most likely to be made by a major shareholder or another holder of a significant economic interest in an entity.

Should This Statement's Requirements for Related Party and Other Economic Interest Holders Also Apply to Compensation Arrangements That Are outside the Scope of This Statement?

B111. The Board discussed whether the accounting for share-based payment awarded to an employee of the reporting entity by related parties or other holders of an economic interest in the entity also should apply to other forms of compensation arrangements that are outside of the scope of this Statement. The Board believes that, in concept, all forms of compensation paid to an entity's employees by related parties or other holders of economic interests in that entity should result in recognition of compensation cost if

the entity effectively receives employee services as a result of such arrangements. However, the Board noted that broadening the scope of this Statement beyond transfers of the entity's share-based payment might require reconsidering other aspects of existing U.S. GAAP applicable to accounting for transactions with related parties. Thus, the Board decided not to expand the scope of this Statement beyond transfers of the entity's share-based payment.

EMPLOYEE SHARE PURCHASE PLANS

B112. Opinion 25 provided that an employee share purchase plan was noncompensatory if it satisfied four criteria: (a) substantially all full-time employees meeting limited employment qualifications might participate, (b) stock was offered to eligible employees equally or based on a uniform percentage of salary or wages, (c) the time permitted for exercise of an option or purchase right was limited to a reasonable period, and (d) the discount from the market price of the stock was no greater than would be reasonable in an offer of stock to shareholders or others. Opinion 25 gave as an example of a noncompensatory plan an employee share purchase plan that qualifies under Section 423 of the U.S. Internal Revenue Code, which may provide a discount of up to 15 percent from the market price of the shares.

B113. Statement 123 included more restrictive criteria than did Opinion 25 for an employee share purchase plan to be considered noncompensatory. Statement 123 provided an exemption only for plans that permitted all eligible employees meeting limited employment qualifications to participate and that (a) included no (or very limited) option features and (b) provided a discount that did not exceed the greater of (1) a discount that would be reasonable in an offering to shareholders or others or (2) the per-share amount of stock issuance costs avoided by not having to raise a significant amount of capital by a public offering. Statement 123 provided a "safe harbor" of 5 percent for applying the second criterion. A discount in excess of 5 percent was permitted only if an entity could justify it.

B114. The Exposure Draft would have established more stringent criteria than those in Statement 123 for an employee share purchase plan to be considered noncompensatory. Under the Exposure Draft, an employee share purchase plan could be considered noncompensatory only if (a) its terms were no more favorable than those available to all holders of the same class of shares and (b) substantially all eligible employees that met limited employment qualifications could participate on an equitable basis.

B115. Many of the respondents to the Exposure Draft who addressed employee share purchase plans said that the proposed criteria for determining whether a plan was noncompensatory were too restrictive. Many of those respondents noted that some

entities raise significant amounts of capital through their employee share purchase plans at lower transaction costs than if the shares were issued by other means. Some respondents also said that looking only to whether the terms of a plan are no more favorable than those available to all holders of the same class of shares effectively looked at the issue from the employees' rather than the employer's perspective. They said that basing the criteria for a noncompensatory plan at least in part on the relative amount of proceeds the employer receives from issuance of shares would be more consistent with the employer perspective reflected in other requirements of the standard. The Board agreed and decided to supplement the criteria in the Exposure Draft with the Statement 123 criteria for determining whether an employee share purchase plan is compensatory, which include a focus on whether a per-share discount provided under an employee share purchase plan results in proceeds to the employer that are no less than the proceeds it would have received in a public offering of shares to raise a significant amount of capital.

B116. Many respondents to the Exposure Draft objected to elimination of Statement 123's 5 percent safe harbor for determining whether a plan is noncompensatory, and some even proposed restoring the effective 15 percent safe harbor in Opinion 25. The Board generally does not favor such bright lines or safe harbors, which are not consistent with a principles-based approach to accounting standards and may reduce the representational faithfulness of the financial statements. However, in this situation in which a bright-line criterion already exists, the Board agreed with respondents that maintaining that criterion could reduce implementation costs without necessarily sacrificing a significant degree of representational faithfulness. The Board therefore decided to continue the 5 percent test in Statement 123.

AWARDS CLASSIFIED AS LIABILITIES

Distinguishing between Awards of Liability Instruments and Awards of Equity Instruments

B117. Concepts Statement 6 distinguishes between liabilities and equity on the basis of whether an instrument obligates the issuer to transfer its assets (or to use its assets in providing services) to the holder. A liability embodies such an obligation, while an equity instrument does not.[151] A call option that an entity writes on its own stock, such as an employee share option, is an equity instrument because its settlement requires

[151]Under Statement 150, certain freestanding financial instruments that embody an obligation to issue equity instruments rather than to pay cash also are classified as liabilities. The interaction of this Statement with Statement 150 is discussed in paragraphs B130 and B131.

only the issuance of stock, which is not the issuer's asset. An entity's obligation under a cash-settled SAR, on the other hand, is a liability because its settlement requires the transfer of assets to the holder.

B118. The Board concluded that the distinction between liabilities and equity instruments in Concepts Statement 6 provides a reasonable way of accounting for tandem awards that offer a choice of settlement in stock or in cash. An entity that grants tandem awards consisting of either a stock option or a cash-settled SAR, for example, is obligated to pay cash upon demand if the choice of settlement is the employee's. The contract gives the entity no discretion to avoid transferring its assets to the employee if the employee elects settlement in cash. The entity thus has incurred a liability. If the choice is the entity's, however, it can avoid transferring assets simply by electing to issue stock, and the award results in the issuance of an equity instrument. However, this Statement requires accounting for the substantive terms of a share-based payment arrangement, as discussed in paragraphs B119–B122, which in some circumstances may override the nominal settlement terms.

Applying Substantive Terms of an Arrangement in Determining Whether a Financial Instrument Qualifies as a Liability or as Equity

B119. Statement 123 (paragraph 39) noted that the substantive terms of a share-based payment arrangement might differ from its written terms and required that the substantive terms be the basis for the accounting. The example provided of substantive terms that might differ from the written terms involved a tandem award in which the choice of whether to settle in cash or equity instruments nominally is the entity's, but the entity generally settles in cash (or settles in cash whenever an employee asks for cash settlement). In that situation, Statement 123 indicated that the entity may have incurred a substantive liability.

B120. This Statement continues that requirement to consider the substantive terms of an arrangement in determining whether the arrangement gives rise to a liability or to an equity instrument. However, in certain recent projects, the Board has established criteria for liability recognition that may be more restrictive than the "substantive terms" requirement of Statement 123. For example, FASB Statement No. 143, *Accounting for Asset Retirement Obligations,* requires recognition of *legal obligations* associated with the retirement of a long-lived asset. Paragraph 2 of Statement 143 defines a legal obligation as one ". . . that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel." *Black's Law Dictionary,* eighth edition, defines *promissory estoppel* as "the principle that a promise made without consideration may nonetheless be enforced to prevent injustice if the promisor should have reasonably

expected the promisee to rely on the promise and if the promisee did actually rely on the promise to his or her detriment." It is not clear whether the counterparty (an employee, in this situation) to a contract that provides for settlement in either cash or shares at the election of the other party to the contract could use the doctrine of promissory estoppel to enforce cash settlement based on an entity's past practices.

B121. The Board and the EITF have encountered in other projects similar issues of whether a liability exists; some of those issues involve the current model for accounting for employee services, while others do not. For example, EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," does not incorporate the same notion of a substantive liability that is included in this Statement. Thus, an instrument for which the entity incurs a substantive liability under this Statement might have been classified as equity had it instead been issued to a third party and thus been subject to Issue 00-19 (and vice versa).[152]

B122. The Board has on its agenda a project on distinguishing between liabilities and equity and accounting for instruments with characteristics of both liabilities and equity. In the course of that project, the Board expects to consider both the conceptual distinction between liabilities and equity and the appropriate criteria for liability recognition. That is, the Board's current project on liabilities and equity may result in changes to both the definition in Concepts Statement 6 and the criteria for liability recognition in various standards. The Board therefore decided not to consider changes to Statement 123's requirements for recognition of a substantive liability at this time. If progress on the Board's project on liabilities and equity suggests that this Statement's substantive liability provision (or any other aspects of this Statement's liability classification criteria) may be inappropriate, the Board will reconsider it at that time.

Certain Provisions That Do Not by Themselves Result in Liability Classification

B123. Paragraph 35 of this Statement states that a provision for employees to effect a broker-assisted cashless exercise of their options does not result in liability classification for instruments that otherwise would be classified as equity, provided that the

[152]For instance, Issue 00-19 specifies that events or actions necessary to deliver registered shares are not controlled by a company and, therefore, except under limited circumstances, such provisions would require a company to assume that the contract would be net-cash settled (and therefore would be classified as either an asset or a liability). Federal securities law generally requires that transactions involving offerings of shares under employee share options be registered, unless there is an available exemption. Thus, employee share options might be classified as substantive liabilities if they were subject to Issue 00-19; however, for purposes of this Statement, the Board does not believe that employee share options should be classified as liabilities based solely on that notion.

exercise is valid and that the employee is the legal owner of the shares subject to the option. A broker that is a related party of the issuer must sell the shares on the open market within a normal settlement period, usually three days, for the provision not to be deemed to result in a liability. This Statement's provisions for broker-assisted cashless exercises are consistent with a related provision of Issue 00-23 concerning the accounting consequences under Opinion 25 of broker-assisted cashless exercises. Because a provision for broker-assisted cashless exercises does not obligate the employer to settle an option in cash or otherwise to transfer cash to the option holder, the Board concluded that such a provision does not result in the options subject to the provision qualifying as liabilities.

B124. Most respondents to the Exposure Draft who addressed the issue agreed with its provisions on broker-assisted cashless exercises, but a few asked that the final Statement explicitly indicate that a cashless exercise of only part of an award also qualifies. The Board agreed that that interpretation is consistent with the intent of the provisions for broker-assisted cashless exercises, and the wording of paragraph 35 has been revised accordingly.

B125. Paragraph 35 of this Statement also indicates that a provision for direct or indirect (by means of a net-settlement feature) repurchase of shares issued upon exercise of options (or vesting of shares) to meet the employer's minimum statutory withholding requirements does not, by itself, result in liability classification of instruments that otherwise would be classified as equity. Interpretation 44 also provided that exception for accounting under Opinion 25. In concept, the Board considers a provision for repurchase of shares at, or shortly thereafter, the exercise of options, for whatever reason, to result in the employer's incurrence of a liability. However, the Board decided for pragmatic reasons to continue the exception for direct or indirect repurchases to meet the employer's minimum statutory withholding requirements.

B126. Certain respondents to the Exposure Draft asked that the exception for minimum statutory withholding requirements be extended to encompass amounts in excess of the minimum statutory withholding requirements. As noted in paragraph B125, the Board included the exception for minimum statutory requirements for pragmatic rather than conceptual reasons. The Board therefore declined to extend the exception beyond the minimum statutory requirements to which the related exception in Opinion 25 and Interpretation 44 applied.

Conditions Other Than Market, Performance, or Service Conditions

B127. Paragraph 33 of this Statement requires that an award be classified and accounted for as a liability if it is indexed to a factor in addition to the entity's share

price and that additional factor is not a market, performance, or service condition. For example, an award of share options with an exercise price that is indexed to changes in the price of a commodity is required to be classified as a liability. The Board concluded that the terms of such an award do not establish an ownership relationship because the extent to which (or whether) the employee benefits from the award depends on something other than changes in the entity's share price. That conclusion is consistent with the Board's conclusion in Statement 150 that a share-settled obligation is a liability if it does not expose the holder of the instrument to certain risks and rewards, including the risk of changes in the price of the issuing entity's equity shares, that are similar to those to which an owner is exposed.[153]

Classification of Certain Instruments Indexed to an Entity's Own Stock

B128. This Statement's definition of a performance condition provides that a performance measure may be defined by reference to the same performance measure of another entity or group of entities. For example, attaining a growth rate in earnings per share that exceeds the average growth rate in earnings per share of other entities in the same industry is a performance condition for purposes of this Statement. In addition, this Statement indicates that a market condition may relate to the achievement of (a) a specified price of the issuer's shares or a specified amount of intrinsic value indexed solely to the issuer's shares or (b) a specified price of the issuer's shares in terms of a similar (or index of similar) equity security (securities). In contrast, paragraph 5 of EITF Issue No. 01-06, "The Meaning of 'Indexed to a Company's Own Stock,'" states:

> . . . instruments within the scope of this Issue are considered *indexed to a company's own stock* within the meaning of Issue 00-19 and paragraph 11(a) of Statement 133 for the issuer provided that (1) the contingency provisions are not based on (a) an observable market, other than the market for the issuer's stock (if applicable), or (b) an observable index, other than those calculated or measured solely by reference to the issuer's own operations (for example, sales revenue of the issuer, EBITDA [earnings before interest, taxes, depreciation, and amortization] of the issuer, net income of the issuer, or total equity of the issuer), and (2) once the contingent events have occurred, the instrument's settlement amount is based solely on the issuer's stock.

[153]The scope of Statement 150 excludes dual-indexed obligations such as the one described, in which the amount, if any, that the holder of an instrument is entitled to receive upon settlement depends on both changes in the value of the entity's equity shares and changes not predominantly based on something else, in this case, changes in the commodity price. However, the Board concluded that the general principle could be applied in this situation, namely, that for a share-settled obligation to be classified as equity, the terms of an obligation must establish an ownership relationship.

Thus, certain instruments, such as an employee share option with an exercise price indexed to the S&P 500, will be classified differently depending on whether they are issued to employees or to third parties because this Statement effectively establishes a definition of market condition that is specific to compensation arrangements. The Board decided to let that potential inconsistency stand for the present, pending progress on its liability and equity project.

Equity Instruments with Exercise Prices Denominated in a Foreign Currency

B129. The Exposure Draft would (implicitly) have required that all equity instruments with exercise prices denominated in a currency other than the currency of the market in which the underlying equity instrument primarily trades be accounted for as liabilities. Certain respondents to the Exposure Draft requested that this Statement include an exception for certain equity instruments with exercise prices denominated in a currency other than the reporting currency, similar to the exception provided in Issue 00-23. The Board agreed that a narrow exception to the requirements of paragraph 33 of this Statement would be appropriate. Accordingly, this Statement (paragraph 33, footnote 19) provides that an award of equity share options granted to an employee of an entity's foreign operation that provides for a fixed exercise price denominated either in the foreign operation's functional currency or in the currency in which the employee's pay is denominated shall not be considered to contain a condition that is not a market, performance, or service condition. Therefore, such an award is not required to be classified as a liability if it otherwise qualifies as equity. For example, equity share options with an exercise price denominated in Euros granted to employees of a U.S. entity's foreign operation whose functional currency is the Euro are not required to be classified as liabilities if those options otherwise qualify as equity. In addition, such options are not required to be classified as liabilities even if the functional currency of the foreign operation is the U.S. dollar, provided that the employees to whom the options are granted are paid in Euros. In this example, however, options with an exercise price denominated in, for instance, the British pound would be required to be classified as liabilities.

Interaction with Statement 150 in Classifying Awards as Liabilities or as Equity

B130. When Statement 123 was issued in 1995, financial instruments were classified as liabilities in accordance with the conceptual definition of liabilities in Concepts Statement 6, which focused on whether the obligations embodied in them called for settlement by transferring cash or other assets (liabilities) or by issuing equity instruments (equity). Statement 123's basis for conclusions indicated that the Board had on its agenda a project on distinguishing between liabilities and equity and accounting for financial instruments with characteristics of both that might change the distinction between liabilities and

equity in Concepts Statement 6. As the first step in that reconsideration, in 2003 the Board issued Statement 150. Statement 150 establishes classification criteria for freestanding financial instruments under which some instruments that do not require the issuer to transfer its cash or other assets (either unconditionally or at the election of the holder) are classified as liabilities rather than as equity. Statement 150 also requires all freestanding instruments that call for settlement by transferring assets, including those issued in the form of mandatorily redeemable shares, to be classified as liabilities.[154] Obligations under share-based payment arrangements accounted for under this Statement are excluded from the scope of Statement 150 until they are no longer subject to this Statement. For example, mandatorily redeemable shares issued upon exercise of an employee share option are subject to Statement 150. Because of the potential overlap of this Statement and Statement 150, the Board considered how best to provide for the interaction between them.

B131. The Board considered amending Statement 150 to eliminate its scope exception for financial instruments accounted for under this Statement and decided not to make that amendment because some of the recognition and measurement requirements of Statement 150 differ from those in this Statement. Nevertheless, the Board believes that, in general, the classification of a freestanding financial instrument should be the same regardless of whether the instrument is issued in a share-based payment transaction or in a financing transaction. Therefore, the Board concluded that this Statement should require that an entity apply the criteria in paragraphs 8–14 of Statement 150 as they are effective at the reporting date in classifying freestanding financial instruments granted to employees under share-based payment arrangements. Paragraphs A225–A232 discuss the interaction of this Statement and Statement 150 in subsequent accounting for instruments that qualify as liabilities under those criteria.

Classification of Certain Instruments Issued by Nonpublic Entities

B132. In November 2003, the Board indefinitely deferred (through FSP FAS 150-3, "Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*") the effective date of the provisions of Statement 150 pertaining to the classification, measurement,

[154]Accounting for mandatorily redeemable shares varied before issuance of Statement 150, but those financial instruments usually were not treated as liabilities for accounting purposes. SEC regulations required public entities to display mandatorily redeemable instruments between total liabilities and equity on the balance sheet, but dividends on those instruments generally were not included with interest expense in determining net income.

and disclosure provisions for certain mandatorily redeemable financial instruments issued by entities that are not SEC registrants. The indefinite deferral applies to all mandatorily redeemable instruments that are not mandatorily redeemable on fixed dates for amounts that either are fixed or are determined by reference to an interest rate, currency, or other external index. Accordingly, an instrument granted to an employee by an entity that is not an SEC registrant that is redeemable upon the employee's retirement or death at the fair value of the instrument at the date of redemption is not subject to Statement 150 unless and until the Board rescinds that indefinite deferral. Classification of certain such instruments was dealt with in paragraph 40 of Statement 123. Those instruments would continue to be classified as equity as long as the indefinite deferral remains in effect in accordance with FSP FAS 150-3. In addition, for internal consistency, the Board concluded that call options written on instruments that continue to be classified as equity due to that indefinite deferral also should be classified as equity while the deferral is in effect.

Classification of Certain Awards with Repurchase Features

B133. Statement 150 does not apply to outstanding shares embodying a conditional obligation to transfer assets, for example, shares that give the employee the right to require the employer to repurchase them for cash equal to their fair value (puttable shares) awarded under share-based payment arrangements. The Exposure Draft did not provide guidance on puttable (or callable) shares issued in share-based payment arrangements. In addition, the Exposure Draft did not contain explicit provisions for freestanding put (or call) options on mandatorily redeemable shares that are subject to the deferral in FSP FAS 150-3. Under Statement 150, such freestanding options would be classified as liabilities although the underlying shares would continue to be classified as equity while the deferral is in effect. Some respondents to the Exposure Draft asked the Board to provide interim guidance on those two issues for entities to apply until the Board completes its project on liabilities and equity.

B134. The Board agreed that interim guidance on the two issues described in paragraph B133 would be appropriate, and paragraph 31 of this Statement accomplishes that. The interim guidance is based largely on practice under Interpretation 44 and Issue 00-23 because the Board believes that interim guidance, in general, should disrupt practice as little as possible. For that reason, the interim guidance in paragraph 31 about what constitutes *a reasonable period of time* continues the bright-line criterion of six months or more. The Board's reluctance to provide bright-lines has already been discussed (paragraph B116), and this Statement does not provide bright-line criteria in areas in which they do not already exist. However, the Board decided that in this situation in which a bright-line criterion already exists in

practice, explicitly providing that entities should continue to use that criterion is preferable to effectively creating confusion on an issue that the Board is considering in another project.

B135. The Board continues to actively consider the distinction between liabilities and equity as part of its liability and equity project, which may eventually change the definitions in Concepts Statement 6. If so, further progress on that project may lead to changes in this Statement's distinction between awards of liability instruments and awards of equity instruments.

Measurement of Awards Classified as Liabilities

Public Entities

B136. This Statement requires public entities to base the measurement of their liabilities under share-based payment arrangements on fair value from incurrence until settlement. In contrast, Statement 123 required that awards of options and equivalent instruments, such as share appreciation rights that require the entity to settle in cash (cash-settled SARs),[155] that qualify as liabilities be measured based on their intrinsic value. Some respondents to the Exposure Draft asked that this Statement continue those provisions of Statement 123.

B137. Statement 123's requirement for intrinsic value measurement of cash-settled SARs and other liabilities continued the requirements of Opinion 25 for those instruments. At that time, the Board noted that whatever the attribute chosen for measuring those instruments initially and in subsequent periods, the final measure of compensation cost would be the amount of cash paid to settle the liability. For a cash-settled SAR, the cash paid would equal the intrinsic value of the instrument at the date it is settled. The main focus of Statement 123 was accounting for employee share options that were equity instruments—not accounting for cash-settled awards about which there had been little controversy. In addition, before Statement 123 was issued and entities began applying it (for either recognition or pro forma disclosures), many entities with share-based payment arrangements had little familiarity with option-pricing models. For those reasons, the Board decided in developing Statement 123 not to require measurement of cash-settled SARs at fair value.

[155]For convenience, the appropriate measurement attribute for liabilities incurred under share-based payment arrangements with employees is discussed in terms of cash-settled SARs, but the discussion applies equally to other liabilities, such as put options.

B138. The Board believes that public entities should account for financial instruments issued to employees under share-based compensation arrangements based on their fair value regardless of whether the instruments are classified as liabilities or as equity. As discussed in paragraphs B56–B58, the Board concluded that fair value is the appropriate measurement attribute for equity instruments, such as share options or share appreciation rights that call for physical settlement by issuing shares (share-settled SARs). For the same reasons, fair value also is the appropriate measurement attribute for similar instruments, such as cash-settled SARs, that are liabilities.

B139. Public entities have been using option-pricing models to estimate the fair value of their equity share options since Statement 123 was issued in 1995. In addition, Statement 133 requires derivative instruments that are similar to cash-settled SARs and other liabilities incurred under share-based payment arrangements to be measured at fair value, which was not the case in 1995. The number and variety of both derivative instruments subject to Statement 133 and similar financial instruments granted to employees as share-based compensation have increased greatly. Finally, as indicated by the classification criteria established by Statement 150, the distinction between liabilities and equity continues to evolve, and the Board may make additional changes to that distinction. After taking all those considerations into account, the Board concluded that requiring public entities to account for liabilities incurred to employees under share-based payment arrangements at intrinsic value is no longer necessary or appropriate. Therefore, this Statement requires that public entities measure liabilities incurred under share-based compensation arrangements at fair value.

Nonpublic Entities

B140. The Exposure Draft would have required a nonpublic entity to make a policy decision of whether to account for its liabilities based on fair value or intrinsic value, which was essentially the same choice proposed in the Exposure Draft for equity instruments of a nonpublic entity. The Board decided for the reasons discussed in paragraphs B94–B101 to eliminate the choice of measurement method for equity instruments granted to employees of a nonpublic entity as compensation. However, for pragmatic reasons, the Board retained the choice of measurement method for liability awards of nonpublic entities. Thus, a nonpublic entity must make a policy decision of whether to measure all of its liability awards at fair value (or calculated value if the nonpublic entity qualifies to use that method for its equity instruments) or at intrinsic value until the date of settlement.

B141. In deciding to permit a nonpublic entity to account for its liability awards based on their intrinsic value, the Board noted that the amount of cash (or other assets) required to settle a liability will be the aggregate measure of compensation cost,

regardless of the attribute used to measure those instruments initially and in subsequent periods. Thus, permitting a nonpublic entity to measure its liability awards, including cash-settled SARs and similar instruments, at intrinsic value reduces the cost that a nonpublic entity will have to incur to apply this Statement without misrepresenting the aggregate measure of compensation cost.

B142. The Board considered whether to extend the same choice between fair value and intrinsic value for liabilities to public entities and decided not to do so. The choice between fair value (or calculated value) and intrinsic value permitted a nonpublic entity is provided for the sole purpose of lowering the implementation cost of this Statement for nonpublic entities and is an exception from what the Board considers to be the preferable method. Most nonpublic entities have a limited number of users of their financial statements, and the cost-benefit tradeoff thus may be viewed somewhat differently than for a public entity. A public entity is likely to have both a larger number of investors and creditors who rely on its financial statements and more sophistication in using and estimating the value of derivatives such as options and option-like instruments than the average nonpublic entity does. Moreover, a public entity is required to account for its awards of equity instruments under share-based payment arrangements at fair value and should have no more difficulty estimating the fair value of its liabilities than it does in estimating the fair value of its equity instruments.

B143. The Board considered whether to require all nonpublic entities to measure their liability awards at intrinsic value. However, the Board understands that some nonpublic entities that plan an initial public offering wish to begin preparing their financial statements in accordance with the generally accepted accounting principles applicable to a public entity in reporting periods before the public offering. Moreover, because fair value is the conceptually preferable measurement attribute, the Board concluded that nonpublic entities should be permitted to use it. Accordingly, this Statement provides that a nonpublic entity may choose to account for all of its liability awards based on their fair value.

ATTRIBUTION OF COMPENSATION COST TO ACCOUNTING PERIODS

Attribution Period

B144. Statement 123 retained the provisions of Opinion 25 and Interpretation 28 that share-based compensation cost is to be recognized over the period or periods during

which the employee performs the related services—the *requisite service period.*[156] Recognizing share-based compensation over the requisite service period is consistent with the manner in which other forms of compensation are recognized. This Statement continues that general requirement, but it explicitly defines the *requisite service period* and introduces the notion of the *service inception date.* This Statement also defines and provides guidance on *explicit, implicit,* and *derived* service periods.

B145. The Board considered whether the attribution period for employee share options should extend beyond the vesting date, perhaps to the service expiration date (paragraph B40), even though the measurement date is the grant date. Advocates of that method, which might be considered consistent with amortization of postretirement health care benefits over the period to *full eligibility date,* contended that employees have not earned the full benefit to which they are entitled until termination of service no longer shortens the life of the option. They would use the longer attribution period to allocate the time value of an option.

B146. Most respondents who addressed this issue agreed with the Exposure Draft that the attribution period should not extend beyond the vesting date. However, some respondents suggested attribution over the option's expected life, which would be consistent with the method described in paragraph B145. They said that the option serves as an incentive during its entire life and that attribution over the longer period would better match recognized compensation cost with the related benefits to the entity, for example, increased revenues.

B147. Although amortization of the time value of an option beyond the vesting date has some conceptual appeal, the Board concluded that no compelling reason exists to extend the attribution period beyond the period now used for share options that give rise to compensation cost. The Board notes that the decision on when to exercise a vested option is the employee's. The right to exercise an option has been earned by the date the option becomes vested.

B148. As noted in paragraph B47, equity instruments are issued to employees when the entity has received the consideration for those instruments (usually, the vesting date). It might be argued that the full amount of the compensation cost resulting from an award of equity instruments should be recognized at the vesting date, once the equity instrument has been fully earned and issued to the employee. However, the cost of services received in exchange for other employee benefits with a vesting period, such

[156]An award may have multiple requisite service periods. For convenience, however, the discussion of attribution of compensation cost in this appendix refers only to a single *requisite service period*.

as pensions and other postemployment benefits, generally is recognized in the periods in which the services are received even if the benefits are not yet vested. Although those employee benefit plans generally result in the incurrence of liabilities rather than the issuance of equity instruments, the Board decided that the form of eventual settlement should not change the general principle that the costs of employee services are recognized over the periods in which employees are required to render service to earn the right to the benefit.

Service Inception Date

B149. This Statement defines the service inception date as the date at which the requisite service period begins. The service inception date usually is the grant date. The service inception date precedes the grant date, however, if service that will count toward vesting begins before a mutual understanding of the key terms and conditions of a share-based payment award is reached *and* either of two conditions applies. Those conditions are (a) the award's terms do not include a substantive future requisite service condition that becomes effective at the grant date *or* (b) the award contains a market or performance condition that if not satisfied during the service period preceding the grant date and following the inception of the arrangement results in forfeiture of the award. Paragraphs A79–A85 further explain and illustrate application of the notion of a service inception date that precedes the grant date.

B150. The Board concluded that adding the notion of a service inception date that precedes the grant date would result in attribution of compensation cost in a manner that is more consistent with application of the current procedures for accounting for the consideration paid for employee services. The objective of that model is to attribute the cost of employee services to the periods in which employees render service in exchange for the consideration paid for those services. It is clear that in some situations, employee service that will count toward, and is necessary for, vesting will begin before the conditions for a grant date are present. In those situations, the Board concluded that the requisite service properly includes the period between the service inception date and the grant date.

B151. This Statement requires that compensation cost for each period between the service inception date and the grant date for an equity award be measured based on the share price and other pertinent factors in effect at each reporting date until the grant date occurs, at which time the estimate of the award's fair value, and thus the related compensation cost, is fixed. Because the grant date is, by definition, the date at which a mutual understanding of the key terms and conditions of an award is reached and because employees do not receive an equity interest before the grant date, it would be inappropriate to measure compensation cost based solely on the share price and other

factors before that date. Accordingly, a cumulative adjustment is recognized in each period between the service inception date and the grant date for the portion of changes in fair value, if any, since the preceding reporting date. Because the measurement date for an equity award is the grant date, interim measures of compensation cost made in reporting periods before the grant date must be subsequently adjusted until the grant date occurs. The Board concluded that retrospective restatement for those differences was not necessary or appropriate, since compensation cost for each period was measured based on the share price and other pertinent factors that existed at the end of each period. Accordingly, the Board concluded that recognizing any needed cumulative adjustment in the period in which it arises would be the best available alternative.

Implicit and Derived Service Periods

B152. This Statement introduces the notions of implicit and derived service periods because an award of share-based employee compensation may not explicitly state a requisite service period or any stated service period may not, in substance, be the period over which employees must render service to benefit from an award.

B153. For instance, an award of share options might not state a service period but rather might provide that the award vests upon the completion of a new product design. That award has an implicit service period of 18 months if the design is expected to be completed in 18 months from the date of grant. Another award might state that it is fully vested at the grant date, but the award is deep out-of-the-money at that date. If, as is usually the case,[157] employees have only a limited period of time after termination of service to exercise a vested option, employees awarded such fully vested, deep out-of-the-money share options must provide service for some period of time in exchange for their awards. In other words, the employees' right to benefit from such an award substantively is contingent on satisfaction of a service condition although none is stated in the award. Thus, at the grant date, the award does not satisfy this Statement's definition of a vested award. Accordingly, the requisite service period must be derived from a valuation technique.

B154. Derived service periods are pertinent only for awards with market conditions. This Statement does not state a preference for a particular model, including a lattice model, for use in estimating the fair value of an equity share option, and it may be possible to estimate the fair value of certain options with market conditions using a

[157]Refer to paragraph A60, footnote 71, for a discussion of the assumption underlying many of the illustrations in this Statement. That is, if the employment relationship is terminated, the award lapses or is forfeited shortly thereafter.

closed-form model. However, the Board understands that it may be necessary to use another valuation technique to determine a derived service period.

Guidance on Derived Service Periods

B155. The Exposure Draft would have required that a derived service period be determined based on the duration of the most frequent path (that is, the mode) of a path-dependent option-pricing model on which the market condition is satisfied. Certain respondents suggested use of either the weighted-average (the mean) or the median (the middle share price path—the midpoint of the distribution of paths—on which the market condition is satisfied).

B156. In reconsidering the guidance to be provided on determining a derived service period, the Board concluded that the median duration of the paths on which the condition is satisfied would provide a better measure of the period over which employees must render service to earn their options (the requisite service period). Because the median is less affected by extreme values than either the mode or the mean, the Board concluded that the median provides a more representationally faithful estimate of the requisite service period.[158]

Accounting for Changes in the Requisite Service Period

B157. This Statement (paragraph 46) provides guidance on when an entity should change its initial estimate of the requisite service period. For example, an award's terms might specify vesting at the date regulatory approval to market a new product is obtained. If the entity estimates at the grant date that regulatory approval will be obtained in two years, the initial estimate of the requisite service period is two years. If it becomes apparent after one year that it is probable that obtaining regulatory approval will instead take three years, the initial estimate of the requisite service period is changed to three years, of which two remain. The effect of that change will be reflected only prospectively, through a longer attribution period than initially estimated. The Board concluded that such a change in estimate is similar to a change in the estimated useful life of, for example, a piece of equipment that is reflected prospectively rather than by means of a cumulative adjustment in the year of the change.

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[158]In a normal distribution, the mean, median, and mode are the same. However, if the distribution is skewed, those values may differ significantly.

Accounting for a Change in the Probable Outcome of an Award with Multiple Performance Conditions

B158. An award may contain multiple performance conditions, the outcome of each of which affects, for instance, the exercise price of share options granted or another factor that affects the fair value of the award. For example, an award of equity share options may specify that an employee will be entitled to 1,000 options with (a) an exercise price of $50 if the market share for a particular product has increased by 10 percent at the end of 2 years or (b) an exercise price of $40 if market share has increased by 20 percent at the end of 2 years. This Statement (paragraph 49) requires that the fair value of the award be estimated at the grant date under each potential outcome. The final measure of compensation cost will be based on the amount estimated at the grant date for the condition or outcome that is actually achieved. If it is deemed probable that the market share will increase by at least 10 percent but not more than 20 percent, accrual of compensation cost will be based on the fair value of the award according to the projected outcome of a 10 percent increase.[159] If the entity changes its estimate of the probable outcome at the end of the first year to a market share increase of 20 percent, a cumulative adjustment must be recognized to reflect the difference between the amount of compensation cost that has been accrued at that date and the amount that would have been accrued if a 20 percent increase in market share had been the original estimate of the probable outcome. Unlike the award in paragraph B157, this award has a different grant-date fair value that is to be recognized as compensation cost as a result of the change in estimate. The Board concluded that a cumulative adjustment is appropriate because it believes that the total amount of compensation cost recognized at the end of each period should be based on the information that is available at that date. That is the same rationale discussed in paragraphs B167 and B168 for the required cumulative adjustment if the estimated number of forfeitures changes during the requisite service period.

[159]Paragraph 44 requires that if an award has multiple performance conditions (for instance, each of which affects the number of options that will vest), compensation cost shall be accrued if it is probable that a performance condition will be satisfied.

Certain Questions about the Effect of Subsequent Share Price Changes on Recognition of Compensation Cost

Why Is Compensation Cost Recognized for Vested Employee Share Options That Expire Worthless?

B159. Some respondents to the Exposure Draft or the Invitation to Comment and others questioned why compensation cost should be recognized for an award of share options that vests but that is not exercised and subsequently expires worthless. The premise of grant-date (and modified grant-date) accounting is that on the grant date (a) the employer and the employee come to a mutual understanding of the terms of a share-based payment arrangement, (b) the employer becomes contingently obligated to issue equity instruments to the employee in exchange for services to be rendered over the requisite service period, and (c) the employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's shares. Equity instruments and the consideration the issuing entity receives in exchange for them are recognized based on their fair values at the date the instruments are issued. For equity instruments awarded to employees, this Statement requires that the estimate of fair value be based on the share price (and other pertinent factors) at the grant date.[160] That fair value estimate is not subsequently adjusted for either increases or decreases in the share price because the employee—not the employer—bears the risk of (and benefits from) share price changes after the grant date.

B160. Once an employee has rendered the requisite service and earned the right to a share option (or other equity instrument), the employer has already benefited from the services received. No change in compensation cost is recognized after vesting (unless the award is subsequently modified) because the exchange transaction is complete at that date—the employee has already rendered the requisite service and the employer has already issued equity instruments. To reverse compensation cost for an award that subsequently expires worthless would disregard the fact that the employer has received services in exchange for the instruments issued to the employee. The accounting for employee share options required by this Statement is substantively the same as the accounting for a share purchase warrant issued to a third party in exchange for cash or other assets. If the warrant expires worthless, the issuing entity retains the premium received (whether cash or services) and paid-in capital has increased by the amount of the premium, even though no shares ultimately were issued.

[160]Refer to paragraph A2 for discussion of the fair value measurement objective under the modified grant-date method required by this Statement. This Statement provides an exception to grant-date fair value measurement for equity instruments for which it is not possible to reasonably estimate fair value. That exception is based on pragmatic rather than conceptual considerations.

Why Is Compensation Cost Recognized for Share Options That Become Deep Out-of-the-Money before the Requisite Service Has Been Rendered?

B161. During the Board's redeliberation of the Exposure Draft, a question was raised about the recognition of compensation cost for certain employee share options and similar instruments that become deep out-of-the-money before an employee has earned the right to them, that is, before the employee has rendered all of the requisite service. The question is whether the exchange transaction entered into at the grant date may sometimes be effectively cancelled or nullified because the options granted have become so deep out-of-the-money that the employee has only a remote possibility of eventually being able to realize a profit by exercising them.

B162. To illustrate this view, consider an award of share options for which the market price of the underlying shares has decreased so significantly by the time 2 years of a 4-year requisite service period have passed that the share price would exceed the exercise price before the options expire on only, say, 30 of 1,000 possible paths in a lattice model used to estimate the fair value of the options. In that situation, some constituents contend that the options no longer are an effective part of the employee's compensation, and the options thus should be treated as if they were cancelled, with no further expense recognized. Those who hold this view consider it to be consistent with the requirement to estimate a derived service period for an option that is deep out-of-the-money and fully vested at the grant date. (Refer to the definition of *derived service period* in Appendix E.)

B163. The Board disagreed with the view described in paragraphs B161 and B162. The employer and an employee are deemed to enter into an agreement at the grant date under which the employer becomes contingently obligated to issue options (or other equity instruments) when the employee has rendered the requisite service to earn the right to benefit from the instruments. Under the modified grant date method, the value of the services to be exchanged for equity instruments, and the related compensation cost, is measured based on the share price and other pertinent factors at the grant date. The employee rather than the employer bears the risk of (and benefits from) share price changes that occur after the grant date. Regardless of the extent of decreases (or increases) in the share price during the requisite service period, the employee is rendering service during that period to earn the *right* to benefit from the options, unless an action is taken to modify or cancel the contract. An employee who vests in an option that at the vesting date has only a small chance of being in-the-money before the end of its contractual term nevertheless has earned the *right* to benefit from that chance. In addition, the view described in paragraphs B161 and B162, like the view discussed in paragraphs B159 and B160, looks at the transaction from the employee's, rather than the employer's, perspective. The employer receives employee services throughout the

requisite service period; under grant-date accounting, those services are measured based on the share price at the grant date. Moreover, even if significant share price decreases during the requisite service period were deemed to effectively cancel an option, the accounting under this Statement would result in recognition of the remaining unrecognized compensation cost at the date of the cancellation.

B164. In contrast, the requirement to determine a derived service period for a deep out-of-the money, nontransferable option that by its stated terms is fully vested at the grant date merely recognizes that the employee must render service after the grant date to benefit from the option (refer to paragraph B153 and footnote 157 for discussion of the assumption about the limited period of time provided for exercise of a vested option after termination of service). In other words, the option is subject to a requisite service period even though it is nominally vested at the grant date. That requirement affects only the period over which compensation cost is recognized. The derived service period is determined at the grant date, and the amount of compensation cost to be recognized for an option that vests is not subsequently changed unless the option is modified to increase compensation cost.

Accounting during the Requisite Service Period for Awards Not Expected to Vest

B165. This Statement requires an entity to base accruals of compensation cost during the requisite service period on the estimated number of instruments for which the requisite service is expected to be rendered. That estimate is subsequently revised if it becomes evident that the actual number of instruments for which the requisite service is expected to be rendered is likely to differ from initial estimates. Statement 123 permitted entities either to use that method or to begin accruing compensation cost as if all instruments subject only to a service requirement were expected to vest and to recognize actual forfeitures as they occur.

B166. In deciding to eliminate the alternative that permitted recognition of the effects of forfeitures as they occur, the Board considered other areas of accounting in which similar estimates are made at initial recognition and subsequently adjusted if necessary, for example, recognition of coupon redemptions and promotional allowances in the retail industry. The Board sees no reason why estimating the number of instruments for which the requisite service is expected to be rendered will be more difficult than making similar estimates in those situations. Entities that have share-based payment arrangements with employees have had to keep track of the number of instruments granted and subsequently forfeited for purposes of either the recognition or the pro forma disclosure requirements of Statement 123. Until sufficient entity-specific information is available, start-up entities may base forfeiture estimates on the experience of other entities in the same industry.

Recognizing the Effect of a Change in the Number of Instruments for Which the Requisite Service Is Expected to Be Rendered

B167. This Statement (paragraph 43) requires an entity to revise its initial estimate of the number of instruments for which the requisite service is expected to be rendered if subsequent information indicates that the actual number of instruments for which the requisite service will be rendered is likely to differ from initial estimates. A cumulative adjustment to compensation cost for the effect on current and prior periods of a change in the estimated number of instruments for which the requisite service will be rendered is required to be recognized in the period of the change.

B168. The Board concluded that a cumulative effect adjustment for a change in the number of instruments for which the requisite service is expected to be rendered is appropriate because it believes that the total amount of compensation cost that has been recognized at the end of each period should be based on the information that is available at that date. Under Opinion 20, the effect of a change in an estimate is not recognized by retrospective restatement because the result of doing so would be to reflect in prior periods' financial statements the effects of information that was not available in those periods. The Board concluded that it would be equally inappropriate to recognize the effect of a change in the estimated number of instruments for which the requisite service will be rendered only prospectively because the result would be to not reflect in financial statements of the current and future periods the full effect of the information available in those periods. Accordingly, the Board concluded that recognizing a cumulative adjustment in the current period was the best available alternative.

Awards with Graded Vesting

B169. Statement 123 provided for two methods of accruing the compensation cost related to awards with graded vesting provisions, although the methods were not described as alternatives for the same set of facts and circumstances. If the fair value of an award was determined based on different expected lives for the options that vest each year, compensation cost was required to be recognized separately over the life of each separately vesting portion. That was the method required for accounting under Opinion 25 by FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans.* That method considers an award with a graded vesting schedule to be in substance separate awards, each with a different vesting date. If the expected life of an award was determined in another manner, Statement 123 permitted the related compensation cost to be recognized on a straight-line basis over the total requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award),

provided that the amount of compensation cost recognized at any date at least equaled the fair value of the vested portion of the award at that date.

B170. The Exposure Draft would have required entities to use the first method described in paragraph B169. In other words, the Exposure Draft would have required an award with graded vesting to be accounted for as separate awards with different requisite service periods. In proposing to require that method, the Board noted that the length of the vesting period of an award is one important factor that influences the expected term of an option because employees cannot exercise nonvested options. In addition, as discussed in paragraph A30, estimates of employees' early exercise and post-vesting employment termination behavior, and thus the related estimates of fair value, are improved if employees are aggregated into groups with relatively homogenous behavior. The length of the vesting period is a significant determinant of that behavior.

B171. Many respondents to the Exposure Draft objected to its proposed method of recognizing compensation cost for awards with graded vesting schedules. Those respondents generally said that both they and employees consider an award with graded vesting to be a single award—not multiple awards. Some also said that the "front-loaded" recognition of compensation cost that results from considering an award with graded vesting to be multiple awards implies that the related employee services become less valuable as time passes, which is not the case. Many of those respondents also said that accounting for an award with graded vesting as effectively separate awards as proposed in the Exposure Draft would be unduly burdensome, especially for entities that grant awards that vest daily or monthly. They said that separately tracking each tranche of such an award for purposes of truing-up the associated tax benefit would be complicated and would require a redesign of their information systems. Certain respondents noted that a lattice model can be designed to take into account a graded vesting schedule. They said that the resulting estimated fair value for the entire award likely would not differ significantly from the weighted average of separately estimated values for each tranche.

B172. In reconsidering the proposed accounting for awards with graded vesting, the Board acknowledged that accounting for them as in substance multiple awards, each with its own requisite service period, is more complicated than accounting for them as a single award. The Board generally agreed with respondents that requiring the multiple-award method for all awards with graded vesting would be an unnecessary refinement. Accordingly, the Board decided to continue to provide a choice of attribution provisions for awards with graded-vesting schedules based only on service conditions. However, the Board eliminated the requirement in Statement 123 that compensation cost for an award with graded vesting be attributed to separate requisite

service periods for each tranche if the fair values of each tranche are separately estimated based on the expected term of each tranche. One respondent noted that a lattice model with separate expected terms for each tranche could be used to estimate the fair value of an award with graded vesting, with a weighted-average expected term for the entire award estimated based on the results of the valuation. The Board agreed that an entity that uses such a method should not be precluded from using the straight-line method to attribute the compensation cost for the entire award, and this Statement thus does not link the choice of attribution method to the valuation method used.

Market Conditions, Performance Conditions, and Service Conditions

B173. In discussing the treatment of various conditions that can affect the vesting, exercisability, or exercise price of an award, paragraph 26 of Statement 123 provided that:

> No compensation cost is recognized for awards that employees forfeit either because they fail to satisfy a service requirement for vesting, such as for a **fixed award,** or because the entity does not achieve a **performance condition,** unless the condition is a target stock price or specified amount of intrinsic value on which vesting or exercisability is conditioned. For awards with the latter condition, compensation cost shall be recognized for awards to employees who remain in service for the requisite period regardless of whether the target stock price or amount of intrinsic value is reached. [Footnote reference omitted.]

A fixed award was defined as one for which vesting is based solely on an employee's continuing to render service to the employer for a specified period of time. A performance award was defined as one for which vesting depends on both (a) an employee's rendering service for a specified period of time and (b) the entity's achievement of a specified performance target, such as attaining a specified growth rate for return on assets or a specified increase in market share for a specified product.

B174. The Board concluded that Statement 123's definitions might not clearly classify some conditions that affect vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award included in instruments awarded under share-based payment arrangements. Thus, this Statement revises the definitions of those conditions to more clearly distinguish between them, although the accounting effects of the revised conditions are not significantly different from the effects of those conditions in Statement 123. The most significant clarification is to separately define *market condition,* which Statement 123 included as one type of performance condition.

This Statement defines market condition as a condition affecting the exercise price, exercisability, or other pertinent factors used in determining the fair value of an award that relates to the achievement of (a) a specified price of the issuer's shares or a specified amount of intrinsic value indexed solely to the issuer's shares or (b) a specified price of the issuer's shares in terms of a similar (or index of similar) equity security (securities).

B175. This Statement continues Statement 123's different accounting for market conditions and performance conditions.[161] That is, no compensation cost is recognized for awards that do not vest because a performance condition is not achieved, even though employees remain in service for the requisite service period. However, compensation cost is recognized for awards to employees who remain in service for the requisite service period regardless of whether (or when) a market condition is satisfied. Some respondents to the Exposure Draft objected to that provision, suggesting that performance and market conditions should be treated the same. Those respondents generally favored recognizing no cost for either if the condition is not satisfied.

B176. The Board decided to maintain the distinction between performance and market conditions, in part due to concerns about the measurability at the grant date of the expected outcomes associated with performance conditions. That is, the Board concluded that it would not be feasible to eliminate the distinction by reflecting the effects of both performance conditions and market conditions in an award's grant-date fair value and recognizing compensation for both if the requisite service is rendered. Although it would be possible, in theory, to estimate the grant-date fair value of an award with a performance condition, to do so would involve developing a probability distribution reflecting the likelihood that the entity will, for example, achieve a specified percentage increase in return on assets in a specified period of time. An entity might have little, if any, data on which to base such a probability distribution, and it would be unlikely to be able to obtain adequate pertinent information about similar awards made by similar entities. Also, the IASB proposed in ED2 a requirement to take into account the effects of performance conditions in estimating an award's fair value at the grant date. Respondents to ED2, as well as to the FASB's Invitation to Comment, generally objected to that proposal on the grounds that it would not be feasible to develop sufficiently reliable estimates of the probability of achieving performance conditions. The Board also was concerned about the potential inconsistency if the effects of performance conditions were taken into account in measuring fair value at the grant date unless the effects of service conditions were treated similarly.

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[161]References throughout the remainder of this appendix to conditions affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award use the terminology and related definitions as they appear in this Statement rather than as they appeared in Statement 123.

B177. The Board also considered eliminating the different accounting for performance and market conditions by requiring recognition of no compensation cost if either type of condition is not satisfied, regardless of whether the requisite service has been rendered. However, based on discussions with members of the Options Valuation Group, the Board understands that the fair value of a share option with a market condition can be estimated at the grant date using valuation techniques developed for similar options that trade in external markets. The Board concluded that it would be inappropriate and illogical not to take advantage of relatively well-developed valuation techniques for those traded options in accounting for awards with market conditions. Therefore, this Statement continues to require recognition of compensation cost for awards with market conditions based on the fair value at the grant date, provided that the requisite service is rendered.

B178. The Board also notes that performance and market conditions are conceptually distinct. Including a performance condition in an award of share-based compensation requires an employee to contribute to achieving an increase in a specified measure of the entity's performance regardless of the extent to which that increase is reflected in the entity's share price. For example, a performance condition may require an increase of 15 percent in market share over a 2-year period. But the entity's share price may not increase accordingly, and may even decrease, even though that condition is achieved.

B179. Market conditions, on the other hand, pertain to the interaction between an entity's individual performance as reflected in its share price and changes in the environment in which it operates. For example, an award of share options with a market condition might have an exercise price that changes in accordance with (that is, is indexed to) changes in the relationship between the entity's share price and an index of the share prices of other entities in the same industry. Changes in measures of the entity's individual performance, such as achieving or not achieving a 15 percent increase in market share, will affect that award only to the extent that the increase is reflected in changes in the entity's share price relative to those of its competitors.

B180. Eliminating the distinction between performance conditions and market conditions would result in only one class of performance-related conditions. That is, a *performance condition* would be defined to include both a performance condition and a market condition as defined in this Statement. In view of both the conceptual differences and the differences in measurability of those conditions, the Board concluded that providing different accounting for them continues to be appropriate.

MODIFICATIONS OF THE TERMS OR CONDITIONS OF EQUITY AWARDS

The Nature of a Modification of Terms or Conditions

B181. Statement 123 required that an entity recognize additional compensation cost if it modified the terms of an award to increase the award's value. Statement 123's basis for conclusions (paragraph 187) explained that a modification of terms is indistinguishable from an exchange of the existing equity instrument for a new instrument. That discussion continued in paragraph 188:

> The repurchase of an equity instrument generally is accounted for based on the fair values of the instrument repurchased and the consideration paid for it. For example, if an entity repurchases shares of common stock at an amount significantly in excess of the current market price of the shares, the excess is presumed to be attributable to stated or unstated rights the issuer receives in addition to the shares surrendered, such as an agreement that the stockholder will not purchase additional shares.

B182. In reconsidering the accounting for a modification of the terms of an award of employee share-based compensation, the Board reaffirmed the conclusion that such transactions generally are transfers of value from the entity to its employees that give rise to additional compensation cost. A modification of the terms of an equity instrument granted to employees as compensation is inherently a transaction between the entity and its employees in their role as employees—not in their role as holders of equity instruments. For instance, a common type of modification is the lowering of the exercise price of an option—a repricing—after a significant decrease in the price of the underlying share. Entities sometimes explain repricings as necessary to restore the incentive value of the options following a share price decrease. Entities provide that benefit to employees (and perhaps certain nonemployee service providers) if the original terms of an option are no longer deemed to provide adequate compensation.

Measuring the Effects of a Modification

B183. Statement 123 required that the effects of a modification be measured as the difference between the fair value of the modified award at the date it is granted and the award's value immediately before the modification determined based on the shorter of (a) its remaining initially estimated expected life or (b) the expected life of the modified award. That method precluded the counterintuitive result that certain modifications favorable to employees could result in reduced compensation cost. However, that

advantage was gained by requiring a difficult-to-explain measurement procedure for the original award—a procedure whose result could not be described as consistent with the fair-value-based method.

B184. This Statement revises Statement 123 to require that the effects of a modification be measured by comparing the fair values (or calculated values for a nonpublic entity that qualifies to use that method) of the modified and original awards at the date of the modification, which is more consistent with the fair-value-based method of accounting for share-based payment arrangements. However, as noted in Statement 123's basis for conclusions, an employee generally will accept a modification only if its effect is to increase the value of the instrument the employee holds. For that reason, the Exposure Draft indicated that total recognized compensation cost for an award *rarely will be less* than the fair value of the award at the grant date unless at the date of the modification the performance or service conditions of the original award are not expected to be satisfied. Some respondents asked the Board to provide guidance on the circumstances, if any, in which a modification, by itself, would appropriately result in recognized compensation cost for the modified award that is less than the grant-date fair value of the original award. The Board decided that it was not feasible to provide criteria for identifying such an unusual—perhaps nonexistent—transaction. However, the Board agreed that the provision should be clarified. Therefore, this Statement indicates that total recognized compensation cost for an equity award shall at least equal the fair value of the award at the grant date unless at the date of the modification the performance or service conditions of the original award are not expected to be satisfied.

Additional Guidance on Accounting for a Modification

B185. This Statement provides more guidance than did Statement 123 on accounting for a modification of the terms or conditions of an award. Appendix A explains and illustrates that guidance. The reasons for the Board's conclusions on the more significant aspects of the additional guidance are discussed in paragraphs B186–B200.

Modifications of Service and Performance Vesting Conditions

B186. This Statement provides guidance on accounting for a modification of the vesting conditions of an award—Statement 123 did not provide explicit guidance on such modifications. The effect of a change in vesting conditions is measured in the same way as other modifications—by comparing the fair values of the award immediately before and after the modification. However, the amount of compensation cost recognized must at least equal the fair value of the original award at the grant date unless at the date of the modification it is not probable that the original vesting

conditions will be satisfied. The combination of that requirement with the application of the modified grant-date method to performance conditions calls for additional discussion.

B187. Under the modified grant-date method, the effects of service and performance conditions are not reflected in the estimated fair value of the award at the grant date. Rather, grant-date fair value is estimated as if each condition was satisfied, and the effect of those conditions is reflected by recognizing compensation cost only for the awards that actually vest. Accrual of compensation cost during the requisite service period is based on the entity's expectation of the awards that will vest. Although the probability that a performance condition will be achieved can vary between zero and one, ultimately a performance condition either is or is not achieved, which means that compensation cost for an award with a performance condition is or is not accrued during the requisite service period.[162] If an award has multiple performance conditions (for example, if the number of options or shares an employee earns varies depending on which, if any, of two or more performance conditions is satisfied), compensation cost should be accrued if it is probable that a performance condition will be satisified. In making that assessment, it may be necessary to take into account the interrelationship of those performance conditions.

B188. In reconsidering the provisions of Statement 123, the Board divided modifications of performance- and service-vesting conditions into four categories:

a. **Type I: Probable-to-Probable.** A service or performance condition is changed in a way that does not affect the estimate of whether the award will vest. An example is a change from an original performance condition, which required a 20 percent increase in market share of Product A, to a modified requirement for a 22 percent increase in market share (or vice versa), when both conditions are expected to be satisfied.
b. **Type II: Probable-to-Improbable.** A service or performance condition is changed in a way that affects the estimate of whether the award will vest by substituting a condition that is not expected to be satisfied for one that was expected to be satisfied. An example is a change from an original performance condition that required a 20 percent increase in market share of Product A and was expected to be achieved to a requirement for a 25 percent increase in market share that is not expected to be achieved.

[162]For simplicity, expected employee terminations before a performance condition is achieved are disregarded in the discussion. That is, even if a performance condition is achieved, some employees likely will have terminated service before the end of the requisite service period.

c. **Type III: Improbable-to-Probable.** A service or performance condition is changed in a way that affects the estimate of whether the award will vest by substituting a condition that is expected to be achieved for one that was not expected to be achieved. An example is a change from a performance condition that required a 20 percent increase in market share of Product A and was not expected to be achieved to a requirement for a 15 percent increase in market share that is expected to be achieved.
d. **Type IV: Improbable-to-Improbable.** A service or performance condition is changed in a way that does not affect the estimate of whether the award will vest by substituting one condition that is not expected to be achieved for another that also is not expected to be achieved. An example is a change from a performance condition that required a 25 percent increase in market share of Product A and was not expected to be achieved to a requirement for a 20 percent increase in market share that also is not expected to be achieved.

B189. Application of the required modification accounting to Types I and IV is relatively straightforward. No additional compensation cost would be recognized at the date of either a Type I or a Type IV modification because the modification changes neither the expectation of whether the vesting condition will be satisfied nor the fair value of the award (unless other terms also are changed). Employees are unlikely to accept Type II modifications (unless perhaps accompanied by changes in other terms or another form of consideration).[163]

Type III Modifications

B190. A Type III modification of a service or performance condition can result in recognition of compensation cost that is less than the estimated fair value of the award at the grant date if expectations about the probability of vesting are accurate. The following example illustrates that situation:

> On February 1, 20X5, an entity grants its vice president for marketing 5,000 at-the-money options with a provision that the awards will vest only if the market share of Product A increases 20 percent by January 31, 20X6. On September 1, 20X5, market share has increased only 12 percent, and the 20 percent goal is not expected to be achieved. On that date, the entity modifies the performance condition to require only a 15 percent increase in market share, which is expected to be achieved. The fair value of each option is $50 at the grant date and $30 on the date of the modification.

[163]Illustration 13 (paragraphs A160–A170) provides examples of Type I, II, III, and IV modifications and describes how the accounting for those modifications is consistent with the principles established in paragraph 51 of this Statement.

B191. The Board concluded that a Type III modification should be accounted for in the same way as other modifications. Thus, on the date of the modification, the fair value of the original award, which is $0 ($30 × zero options expected to vest under the original target) in the example, is subtracted from the fair value of the modified award, or $150,000 ($30 × 5,000 options expected to vest under the modified target). If the modified target in the example is ultimately satisfied, the total recognized compensation cost ($150,000) will be less than the fair value of the award at the grant date ($250,000) because at the date of the modification, the original vesting conditions were not expected to be satisfied. The Board considers that accounting for a Type III modification to be consistent with both the modified grant-date method and the requirements for accounting for a modification of the terms or conditions of an award. The Board also notes that its conclusions on Type III modifications would result in recognizing compensation cost that exceeds the fair value of the award at the grant date if the fair value of the award at the modification exceeds that amount. However, that situation may be less common than the one illustrated because failure to satisfy an original performance condition may be correlated with decreases in the price of the underlying share.

B192. Some respondents to the Exposure Draft favored adopting the requirements of IFRS 2 for Type III modifications. Under IFRS 2, the modification in the preceding example would be accounted for as a change only in the number of options expected to vest (from zero to 5,000), and the full grant-date fair value of the award ($250,000) would be recognized over the remainder of the service period. That result is the same as if the modified performance condition had been in effect at the grant date. If the fair value of the award at the modification date exceeds its fair value at the grant date, however, IFRS 2 would require recognition of the higher amount as compensation cost.

B193. The respondents who favored IFRS 2's accounting for Type III modifications generally were concerned about the necessary judgment about the probability of meeting the original performance condition required at the date of the modification to apply the method proposed in the Exposure Draft. In deciding to retain that method, the Board noted that judging whether it is probable that a performance condition will be satisfied is fundamental to applying the modified grant-date method. The Board also notes that the principles of accounting for a modification of an equity award in paragraph 51 of this Statement require that the amount of compensation cost recognized after a modification of the terms or conditions of an award at least equal the fair value of the award at the grant date, *unless at the date of the modification the performance or service conditions of the original award are not expected to be satisfied.* The emphasized phrase is significant for Type III modifications of equity instruments. In a modification that makes it probable that a vesting condition will be achieved, the

original vesting conditions ordinarily will not be expected to be achieved, and the grant-date fair value of the award thus is not a floor on the amount of compensation cost recognized.

A Modification That Changes the Classification of an Award from Equity to Liability

B194. The Board's conclusions on a modification of the terms of an award that changes its classification from an equity instrument to a liability are consistent with its conclusions on accounting for other modifications of awards of equity instruments. In particular, the minimum amount of compensation cost to be recognized is the fair value of the instrument at the date it was granted, unless at the modification date the original vesting conditions are not expected to be satisfied. To illustrate, if an entity modifies a vested award of share options to add a feature under which the employee may elect cash settlement of the intrinsic value of the options at the exercise date, a financial instrument that formerly was classified as equity instead will be classified as a liability because the entity is obligated to pay cash if the employee elects cash settlement. If the fair value of the award is $500,000 at the grant date and $400,000 at the modification date, no decrement to compensation cost is recognized at the modification date because the previously recognized grant-date fair value of the award is the minimum compensation cost. Rather, the fair value of the liability at the modification date is reclassified from paid-in capital to the liability resulting from the modification. If the liability subsequently is settled for $400,000 (or any amount less than $500,000), no increase in net income is recognized because compensation cost must at least equal the grant-date fair value of the original equity award. That grant date-fair value "floor" still applies because the award was an equity award at the date it was granted. The Board considered whether changes in the fair value of the liability subsequent to the modification date when the fair value of the liability is less than the grant-date fair value of the equity award should be recognized in other comprehensive income rather than in paid-in capital. The Board decided that that issue would be better addressed in a broader project on other comprehensive income.[164] In reaching that decision, the Board noted that FASB Statement No. 130, *Reporting Comprehensive Income,* describes several potential items of other comprehensive income that could be addressed as part of a broader project in the future.

[164] The Board noted that essentially the same issue arises for clawback provisions if the fair value of the consideration received exceeds the recognized compensation cost for the share-based payment arrangement that contained the contingent feature.

A Modification That Changes the Classification of an Award from Liability to Equity

B195. The Exposure Draft proposed that the principle that total compensation cost for a modified award must at least equal the grant-date fair value of the original award also would apply to a modification that changes the classification of an award from liability to equity. For example, if a vested award of cash-settled SARs was modified to replace required cash settlement with net share settlement, an instrument that qualified as a liability before the modification is effectively converted to an equity instrument. If the value of the liability was $500,000 at the grant date and is $400,000 immediately before the modification, the Exposure Draft would have required recognition of additional compensation cost of $100,000 at the date of the modification. That accounting produced the same result as if the award had been an equity instrument from the grant date.

B196. Some respondents to the Exposure Draft objected to that requirement on the grounds that the fair value of an award at the grant date is not relevant to liability awards, which are accounted for based on their fair value at each reporting date until exercise or other settlement. Those respondents said that a modification such as the one in paragraph B195 effectively settles the liability existing at the modification date in exchange for issuing an equity instrument with the same fair value, which is the way such modifications are accounted for under IFRS 2. The Board agreed with that view of the effect of a liability-to-equity modification and revised the Exposure Draft's requirements accordingly as illustrated in paragraphs A182–A184. Thus, in the preceding example, the award is accounted for as equity beginning at the date of the modification, with an effective grant-date fair value of $400,000.

Cancellations and Replacements

B197. The Board concluded that certain cancellations of awards accompanied by the grant of a replacement award are indistinguishable from modifications of the terms or conditions of the original award. For example, an entity might effectively reprice an award of share options with an exercise price of $50 by taking either of the following actions:

a. Modifying the terms of the award to lower the exercise price to $40
b. Cancelling the original award and concurrently granting a new award of share options with an exercise price of $40, a shorter contractual term, and subject to the same conditions as the original award.

In either case, the effect is the same—employees who previously had share options with an exercise price of $50 now have share options with an exercise price of $40.

B198. The Board considered what guidance to provide on distinguishing between a cancellation and grant of a replacement award that is substantively a modification and a cancellation of an award that should be accounted for as a settlement, with any replacement award accounted for separately. The Board concluded that a modification of an award, regardless of whether that modification is in the form of a cancellation of an existing award and grant of a replacement award, would be explained as such to the employees affected by the transaction. Thus, a cancellation and grant of (or offer to grant) a replacement award must occur concurrently if the transaction is to be accounted for as a modification. Otherwise, cancellation of an award is accounted for as a settlement in accordance with paragraphs 55 and 57 of this Statement.

Effect of Modifications on Determining Whether a Grant Date Has Occurred

B199. One criterion for determining whether a *grant date* has occurred under the definition in this Statement is that the employer and an employee must have reached a mutual understanding of the key terms and conditions of a share-based payment arrangement. The effect of a modification is to change one or more of those terms or conditions, such as the exercise price of a share option.

B200. The Board considered whether multiple modifications of the same award might in some circumstances indicate that an employer and employees who benefit from the change(s) to their awards no longer have a mutual understanding of the award's key terms and conditions. The accounting result of a determination that such a mutual understanding does not exist would be to account for that award, and possibly similar awards, based on their estimated fair value at each reporting date until settlement. The Board considered several possible means of identifying awards to be accounted for as if a grant date has not yet occurred and concluded that each possible method could result in significant implementation problems. The Board also noted that most modifications of awards will result in recognition of incremental compensation cost. Accordingly, the Board decided not to establish special accounting requirements for multiple modifications of the same award.

Subsequent Accounting for Certain Freestanding Financial Instruments

B201. This Statement requires that the provisions of Statement 150, paragraphs 8–14, be applied in determining whether awards of freestanding financial instruments to employees as compensation qualify as liabilities. Paragraphs B202–B206 discuss subsequent accounting for certain financial instruments classified as liabilities in accordance with Statement 150.

B202. The Board considered when a financial instrument granted to an employee in a share-based payment transaction should cease to be accounted for under this Statement and should become subject to the requirements of other applicable GAAP, including Statements 133 and 150, as well as Issue 00-19.[165] This Statement deals with all aspects of measuring and recognizing financial instruments issued in exchange for employee services and the related compensation cost. In contrast, the financial instruments dealt with by other applicable generally accepted accounting principles, such as Statements 133 and 150, generally are issued in exchange for cash or other financial instruments, that is, in financing transactions. Therefore, those instruments generally give rise to interest cost or other cost of goods or services received rather than compensation cost. Accordingly, the Board concluded that this Statement should govern the accounting for a freestanding financial instrument granted to an employee until the rights conveyed to the holder of the instrument are no longer dependent on the holder's being an employee of the entity (that is, the rights are no longer dependent on continuing to provide service).

B203. An employee ordinarily is able to terminate service with vested shares (as opposed to share options or similar instruments) and still retain all rights inherent in the shares. Therefore, instruments such as mandatorily redeemable shares or other nonvested shares generally will become subject to Statement 150 upon vesting.

B204. A share option or similar instrument that is not transferable and whose contractual term is shortened upon employment termination continues to be subject to this Statement until the rights conveyed by the instrument to the holder are no longer dependent on the holder's being an employee of the entity (generally, when the instrument is exercised). However, vested share options are typically exercisable for a short period of time (generally, 60 to 90 days) subsequent to the termination of the employment relationship. The Board does not intend such a provision, in and of itself, to cause the award to become subject to other applicable GAAP for that short period of time.

B205. An entity may modify the terms of a fully vested, freestanding financial instrument after it becomes subject to Statement 150 or other applicable GAAP. The Board considers a modification of the terms of a financial instrument, such as a repricing of share options, held by current or former employees to be a transaction

[165]The wording of the related paragraphs of the Exposure Draft dealt only with when an instrument ceases to be subject to this Statement and becomes subject to Statement 150. Respondents to the Exposure Draft pointed out that certain freestanding financial instruments may become subject to pronouncements other than Statement 150 when they cease to be subject to this Statement. The wording of this Statement has been revised in response to those comments.

between the entity and those parties in their roles as employees rather than in their roles as holders of equity instruments. Any incremental value provided by the modification thus is additional compensation. Therefore, under this Statement, a modification that does not apply equally to all financial instruments of the same class regardless of whether the holder is or was an employee (or an employee's beneficiary) is a share-based payment transaction to be accounted for under the requirements of this Statement. Subsequently, the modified instrument will continue to be accounted for under Statement 150 or other applicable GAAP.

B206. Some classes of financial instruments are held only by current (or perhaps former) employees or their beneficiaries. The common shares of an entity that is wholly owned by its employee fall into that category. The Board concluded that modifications or settlements of such financial instruments may stem from the employment relationship depending on the terms of the modification or settlement. Thus, such a modification or settlement may be subject to the requirements of this Statement.

ACCOUNTING FOR INCOME TAX EFFECTS OF AWARDS OF SHARE-BASED COMPENSATION

Awards of Equity Instruments

B207. Consistent with the original provisions of Statement 123, the Board concluded that compensation cost recognized in the financial statements should be accounted for as a temporary difference under FASB Statement No. 109, *Accounting for Income Taxes*. Any deferred tax asset that is recognized for that temporary difference is not remeasured during the period that an award is outstanding for changes in the amount that would be deductible for tax purposes at subsequent balance sheet dates due to changes in the entity's share price but that are not recognized in measuring compensation cost.

B208. Under U.S. tax law at the date this Statement is issued, the tax deduction for an award of share-based compensation is based on the intrinsic value of the related instruments determined at a date after the grant date—generally the exercise date for share options (or equivalent instruments) and the vesting date for shares. The ultimate tax benefit for an equity award thus may be higher or lower than the temporary difference recognized for accounting purposes.

B209. The Board concluded that tax deductions in excess of recognized compensation costs that result from increases in intrinsic value after the grant date (that is, excess tax deductions) are due to changes in the price of an equity instrument. Therefore, the

related tax effect (or excess tax benefit) should be an adjustment of paid-in capital. The result of that accounting is that the tax effects of an award of share-based employee compensation that qualifies as equity affect both the income statement and paid-in capital because the total tax deduction pertains to two separate transactions or events:

a. A transaction in which employees render services as consideration for an award of equity shares, equity share options, or other equity instruments. Use of those services in the entity's operations results in compensation cost, which is an income statement item.
b. An equity transaction, such as the exercise of share options or the vesting of shares. Changes in the share price after the grant date affect the amount of that equity transaction.

B210. If the tax benefit for an instrument is less than the amount of the related deferred tax asset, referred to as a *tax deficiency* in this discussion, this Statement requires, as did Statement 123, that the write-off of the deferred tax asset be recognized in the income statement except to the extent of any remaining paid-in capital arising from excess tax benefits from previous awards accounted for using the fair-value-based method. The Exposure Draft would have revised that provision to require that the full amount of a tax deficiency be recognized in the income statement. That proposal was based on viewing the tax effects of share-based compensation awards on an individual instrument basis; Statement 123's provisions, on the other hand, were consistent with accounting for the tax effects of awards on a group or portfolio basis.

B211. Some respondents to the Exposure Draft agreed with the method that it proposed. They generally said that the portfolio approach of netting tax deficiencies on some instruments against excess tax benefits on other instruments was not appropriate because one potential effect was to recognize in income a tax benefit on instruments awarded to an individual employee greater than the tax benefit received for those instruments.

B212. However, the majority of respondents to the Exposure Draft who addressed the issue disagreed with the proposed individual instrument requirement. They proposed a variety of other methods, including recognizing both excess tax benefits and tax deficiencies in the income statement or recognizing both in equity. Some respondents supported the original Statement 123 method. Most respondents said that the method they favored was more consistent with the income tax accounting principles in Statement 109. Many respondents who disagreed with the method in the Exposure Draft argued that the required tracking of tax effects of individual awards was unnecessarily complex. Some also said that the Exposure Draft method was inconsistent with other aspects of the fair-value-based accounting method, for example,

reflecting the effects of employees' expected forfeiture and post-vesting employment termination behavior, that are based on a portfolio rather than an individual instrument approach.

B213. The Board rejected recognizing both excess tax benefits and tax deficiencies in the income statement because that view is consistent with viewing the entire tax deduction as the result of a single transaction in which employees render service in exchange for compensation in the form of equity instruments. As noted in paragraph B209, the Board concluded that the tax deduction results from both a compensatory transaction and a separate transaction in which the employer issues equity instruments to employees (or the award is otherwise settled, such as by expiration of a share option).

B214. The Board also rejected a method that would recognize both excess tax benefits and tax deficiencies in paid-in capital. The net result of recognizing the full amount of a tax deficiency in equity would be to recognize unrealized tax benefits for compensation cost as if they had been realized, which would overstate the entity's cumulative net income.

B215. Some respondents proposed a method of accounting for the tax consequences of awards of share-based compensation based on creation of a notional prepaid compensation asset on the grant date that exists as a notional reduction in equity. Under that method, a deferred tax liability would be recognized on the date an at-the-money share option is granted because that notional prepaid compensation asset is deemed to have no tax basis as it has no intrinsic value. As compensation cost was recognized over the requisite service period, the deferred tax liability would be eliminated by credits to income tax expense. Tax benefits, if any, realized upon exercise of the option then would affect only current taxes payable and paid-in capital. The net effect of that method would be that neither excess tax benefits nor tax deficiencies are recognized in the income statement. The Board rejected that method because it would result in recognition of a liability at the grant date that does not satisfy the definition of a liability. In addition, as discussed in paragraph B72, the Board concluded that an entity does not have a prepaid compensation asset at the grant date. It would be inconsistent with that conclusion to account for the tax consequences of an award of equity share options or similar instruments as if a prepaid compensation asset—notional or otherwise—was created at the grant date.

B216. The Board concluded that none of the methods discussed were clearly superior to the others in terms of consistency with the income tax accounting principles in Statement 109. The Board also noted that public entities already have been applying Statement 123's portfolio approach to recognizing excess tax benefits. That method not

only is familiar, but also is somewhat easier to implement than the method in the Exposure Draft. Accordingly, this Statement continues the original Statement 123 method in which tax deficiencies are recognized in the income statement except to the extent of any remaining paid-in capital arising from excess tax benefits from previous awards subject to Statement 123.

B217. The Board was asked to specify which excess tax benefits are available as offsets to tax deficiencies. Because this Statement continues the fair-value-based method in Statement 123, the Board concluded that the "pool" of excess tax benefits available for offset should include those from all awards that were subject to Statement 123. That includes excess tax benefits recognized if the fair-based-method was adopted for recognition purposes, as well as those that would have been recognized had an entity that provided pro forma disclosures instead adopted Statement 123's fair-value-based method for recognition. However, excess tax benefits that have not been realized pursuant to Statement 109, as noted in paragraph A94, footnote 82, of this Statement, are not available for offset. The Board was informed by some constituents that a practice has developed whereby some entities recognized deferred tax assets for excess tax benefits before they were realized. The Board understands that such practice may be prevalent and therefore decided to provide transition guidance that requires an entity to discontinue that policy prospectively and follow the guidance in this Statement and Statement 109.

Awards of Liability Instruments

B218. This Statement provides guidance on accounting for the income tax effects of awards of liability instruments to employees in share-based payment transactions. Statement 123 did not address that issue because its required measurement date (settlement date) and measurement attribute (intrinsic value) for those liabilities were the same as the measurement date and attribute generally used for tax purposes. However, this Statement revises Statement 123 to require that awards of liability instruments by public entities be measured at fair value rather than intrinsic value. (Nonpublic entities may elect to use intrinsic value.) That requirement resulted in the need to address whether the excess of fair value over intrinsic value should be accounted for as a temporary difference under Statement 109. The Board concluded that it should.

Book and Tax Measurement Basis for Share Options

B219. The Board concluded that the deferred tax benefit for an award of share options recognized at the time the related compensation cost is recognized should be measured based on the fair value (or calculated value for certain nonpublic entities) of the options,

including time value, because that method is consistent with the measurement of the related compensation cost. The Board does not consider a portion of the total difference between book and tax accounting for an award of share options to result from a difference in measurement basis (fair value and intrinsic value, respectively). At the date share options are exercised (or lapse unexercised at the end of their contractual term) and the actual tax deduction (if any) is determined, fair value (or calculated value) and intrinsic value are the same. At that date, either the employee has sacrificed the remaining time value upon early exercise or the time value has expired because the option has reached the end of its contractual term. Accordingly, the Board concluded that the difference between book and tax accounting under existing U.S. tax law results solely from different measurement dates and not from different measurement bases.

B220. Some respondents to the Exposure Draft favored the approach in IFRS 2 in which the deferred tax benefit is measured based on the intrinsic value of the award at the date the tax benefit is recognized. That approach is consistent with viewing the difference between book and tax accounting under existing U.S. tax law as resulting from different measurement attributes (fair value versus intrinsic value) as well as different measurement dates. The Board acknowledges that the IASB's conclusion is more consistent with the general approach to accounting for deferred taxes under both Statement 109 and IAS 12, *Income Taxes.* However, the Board decided to retain the existing departure from that basic tax-accounting model for the reasons noted above.

Accounting for the Deferred Tax Asset between Grant Date and Exercise Date

B221. Once a deferred tax asset pertaining to an award of share-based employee compensation is established as the related compensation cost is recognized, Statement 123 required that the effect of subsequent changes in the share price not be reflected in accounting for the deferred tax asset before that compensation is recognized for tax purposes. Rather, the deferred tax asset would be subsequently reduced by a valuation allowance only if, based on the weight of the available evidence, it is more likely than not that future taxable income[166] will be insufficient to recover the deferred tax asset in the periods the tax deduction for the award will be recognized (or in a carryback or carryforward period).

[166]Paragraph 21 of Statement 109 states, "Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carry-forward period available under the tax law." That paragraph goes on to describe the four sources of taxable income that may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards.

B222. Some commentators preferred the IFRS 2 approach to accounting for the deferred tax asset. IFRS 2 requires that the deferred tax asset be remeasured based on the share price at each reporting date before the deduction is recognized for tax purposes (or not recognized because an option is not exercised). The IASB concluded that reflecting changes in the share price before the deduction is recognized for tax purposes would be more consistent with other aspects of accounting for income taxes under its applicable accounting standard. As noted in paragraph B220 of this Statement, the FASB believes that treatment also could be viewed as conceptually consistent with Statement 109, but it decided for practical reasons to retain Statement 123's requirements. The Board also concluded that those requirements are consistent with its conclusion discussed in paragraphs B161–B164 of this Statement, in which a significant decrease in the share price after the grant date but before vesting does not result in ceasing to recognize compensation cost measured at the grant date.

AMENDMENTS TO STATEMENT 95

B223. FASB Statement No. 95, *Statement of Cash Flows,* requires an entity to provide a statement of cash flows that reports cash receipts and payments during the reporting period, classified according to whether they result from operating, investing, or financing activities. As originally issued, Statement 95 required all income tax payments (or refunds) to be classified as operating cash flows. In paragraph 92 of Statement 95, the Board explains that ". . . allocation of income taxes paid to operating, investing, and financing activities would be so complex and arbitrary that the benefits, if any, would not justify the costs involved." The Board continues to consider that conclusion generally accurate. However, it decided for the reasons discussed in paragraphs B224–B228 of this Statement to make an exception for the effects of excess tax benefits. Those excess tax benefits reduce the taxes otherwise payable when increases in the intrinsic value of equity instruments issued to employees are deductible for tax purposes but are not recognizable for accounting purposes.

B224. As discussed in paragraph B209, this Statement considers the tax effects of equity instruments awarded to employees to result from two transactions or events. Under that view, tax deductions that result from increases in intrinsic value after the grant date in excess of the grant-date fair value of the instruments awarded are considered to be due to an equity transaction, and the resulting excess tax benefits thus are recognized as an adjustment of paid-in capital. Thus, the tax effects of an award of share-based employee compensation affect both an income statement item and an equity item because the total tax deduction pertains to two separate transactions or events.

B225. For some entities, the tax savings realized upon employees' exercise of share options have significantly reduced the amount of income taxes otherwise payable. As a result, questions arose concerning the reporting of the net amount of taxes paid as an operating cash flow, especially since for income statement purposes the reduction in taxes otherwise payable is effectively accounted for as a part of the equity transaction when employees exercise their options (or shares vest). Some argued that the amount of the tax reduction should be classified in the statement of cash flows as resulting from a financing activity. In July 2000, the EITF considered that issue and concluded that entities should classify the amount of taxes paid as an operating cash payment because that is what Statement 95 required.[167] At that time, however, the Board agreed to reconsider the issue if it subsequently undertook a project on accounting for share-based payment.

B226. Advocates of retaining the original provisions of Statement 95 on classification of taxes paid, including many of the respondents to the Exposure Draft who addressed this issue, noted that the primary objective of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an enterprise during a period (Statement 95, paragraph 4). They pointed out that a reduction in taxes otherwise payable is not a cash receipt, nor is the related amount of taxes that would have been payable in the absence of a particular tax deduction a cash payment. Proponents of reporting the deemed tax saving as a result of excess tax benefits with cash flows from financing activities noted that net operating cash flows often are used as an indicator of the liquidity or "nearness to cash" of net income. For that reason, they advocated restricting operating cash flows, to the extent feasible, to the cash flow effects of transactions and events that enter into the determination of net income. The tax benefit in question, they pointed out, while not a cash receipt, is a "cash flow effect" of a financing activity that does not enter into the determination of net income.

B227. The Board acknowledges that both views on this issue have merit, but, on balance, it concluded that Statement 95 should be amended to report the tax reduction from excess tax benefits in the financing section of the statement of cash flows. The Board concluded that this item differs from other components of taxes paid that might be allocated among categories in the statement of cash flows because this item involves both compensation cost included in the income statement and an adjustment of paid-in capital as a result of an issuance of shares—a financing transaction. The Board also decided that the amendment of Statement 95 should apply to share-based payment transactions with nonemployees so that similar economic transactions are accounted for

[167]Refer to 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."

similarly. The amendment to Statement 95's treatment of taxes paid to report deemed tax savings from excess tax benefits as resulting from a financing activity also removes a potential point of nonconvergence with IFRS 2.

B228. The Board considered whether the cash flow statement should report an increase in operating cash flows and a decrease in financing cash flows in a reporting period in which there is a charge to paid-in capital as a result of the write-off of a deferred tax asset related to an award that did not result in deductible compensation cost. The Board decided not to require that presentation because it believes that the operating and financing sections of the cash flow statement should reflect only the effects of awards that generated tax savings from excess tax benefits.

DISCLOSURES

Objectives-Based Approach

B229. Because Statement 123 permitted entities to continue to use Opinion 25's requirements if they chose, many equity instruments granted to employees resulted in no compensation cost being recognized in the financial statements. As a consequence, Statement 123's disclosure requirements were developed in the context of recognition provisions that would not necessarily result in financial statements that adequately accounted for the economic effects of share-based payment arrangements with employees. Thus, one purpose of those disclosure requirements was to mitigate the inadequate accounting for share-based employee compensation arrangements under Opinion 25. The pro forma disclosures were the most obvious example of disclosures intended for that purpose, and this Statement eliminates those disclosures prospectively. The Board also reevaluated Statement 123's other disclosure requirements in light of this Statement's requirement to recognize the compensation cost from share-based payment arrangements in accordance with the fair-value-based method.

B230. The Board believes that a principal purpose of disclosures is to explain and elaborate on information recognized in the financial statements. The Board also notes that IFRS 2 establishes specific disclosure objectives for share-based payment arrangements and indicates minimum disclosures that would be needed to achieve each objective. Some respondents to the Invitation to Comment commented favorably on that approach, and the Board agrees that an objectives-based approach to disclosure requirements has merits. This Statement thus establishes four specific disclosure objectives (paragraph 64). Paragraph A240 indicates the minimum disclosures needed to achieve each objective, and paragraph A241 illustrates how the minimum requirements might be satisfied.

B231. Respondents to the Exposure Draft generally supported the objectives-based approach to disclosures, as well as the specific objectives proposed in the Exposure Draft. Some, however, asked the Board to establish a significance threshold below which some or all of the disclosures need not be provided. The Board notes that each of its Statements is accompanied by an indication that its provisions "need not be applied to immaterial items." The Board considers that general materiality provision to be preferable to establishing bright-line thresholds for a variety of items.

Information about the Nature and Terms of Share-Based Payment Arrangements

B232. The Board concluded that an important disclosure objective is to provide information that enables users of financial statements to understand the nature and terms of share-based payment arrangements with employees that existed during the reporting period and the potential effects of those arrangements on shareholders (paragraph 64(a)). Information needed to understand the potential effects of share-based payment arrangements on shareholders includes, but is not necessarily limited to, information about the potential transfer of value from preexisting shareholders to option holders upon exercise of in-the-money options. That objective was implicit in many of the disclosure requirements of Statement 123.

B233. The minimum disclosures this Statement specifies as necessary to achieve the objective discussed in paragraph 64 were required by Statement 123, and many of them also were required by Opinion 25. Thus, entities have for many years been disclosing items such as the nature and terms of share-based payment arrangements and a reconciliation of instruments outstanding at the beginning and end of the year. Those disclosures generally have been considered useful and have not been controversial.

B234. Statement 123 required entities to disclose the items specified in paragraph A240(b) of this Statement for each year for which an income statement was provided. Thus, an entity that presented comparative financial statements had to disclose, for example, the number and weighted-average exercise price of options granted, exercised, forfeited, or expired during a given year not only in the notes to that year's financial statements but also in the notes for succeeding years in which that year's financial statements are presented for comparative purposes. Although the Board continues to consider those disclosures important, it concluded that they are necessary only for the current year. The Board is not aware of a significant use or need for comparative disclosures of, for example, a reconciliation of the number of share options outstanding at the beginning of the year with those outstanding at the end of the year. Moreover, users who wish to see reconciliations for earlier years can consult the notes to the financial statements for those years. However, the Board concluded that the items

specified in paragraph A240(c), such as the weighted-average grant-date fair values (or calculated values) of equity options and other equity instruments granted during the year, should be required for all periods presented to facilitate an understanding of trends.

B235. Statement 123 required disclosure of both (a) the weighted-average exercise price of options outstanding at the beginning of the year, those outstanding at the end of the year, and those granted, exercised, forfeited, or expired during the year and (b) the range of exercise prices of options outstanding at the date of the latest statement of financial position presented. The Board concluded that ranges of exercise prices are not an essential disclosure. The Board understands that ranges of exercise prices, by themselves, are not adequate to enable users to understand the potential increase in outstanding shares as a result of option exercises. Accordingly, the Board decided to retain only the required disclosure of weighted-average exercise prices. However, the Board emphasizes that paragraph A240(b) of this Statement specifies only minimum disclosures needed to achieve the objective of enabling users to understand the nature and general terms of share-based payment arrangements with employees that existed during the reporting period and the potential effects of those arrangements on shareholders. An entity that considers ranges of exercise prices also to be important in achieving that objective can provide that disclosure.

B236. This Statement requires disclosure of the total intrinsic value of options exercised (or share units converted) and share-based liabilities paid during the year (paragraph A240(c)). Some respondents questioned the need for intrinsic value disclosures in light of this Statement's focus on fair value. Under the modified grant date method, the amount of compensation cost recognized for awards of equity instruments ordinarily will differ from the value of the equity eventually issued (for example, upon vesting of nonvested shares or exercise of share options). The Board concluded that those intrinsic-value-based disclosures are important to provide information about the effect of outstanding share-based payment instruments on shareholders.

Information about the Effect of Compensation Cost on the Income Statement

B237. The Board concluded that information should be provided to enable users of the financial statements to understand the income statement effect of compensation cost arising from share-based payment arrangements with employees. Paragraph A240(g) specifies minimum disclosures needed to achieve that objective. Many of those disclosures, such as the total compensation cost recognized in income, also were required by Statement 123. However, the Board decided that certain other disclosures not specified by Statement 123 also are important in achieving the stated objective.

B238. To understand the effects of share-based payment arrangements on the income statement, users need to know not only the compensation cost recognized in income but also the related tax effects recognized in income. Users of financial statements, including many of those who responded to the Invitation to Comment, also asked for information to help understand the potential effects on future income statements of compensation cost resulting from outstanding awards. The Board considered that request to be both reasonable and consistent with the disclosure objectives. Accordingly, this Statement requires disclosure of total compensation cost related to nonvested awards that has not yet been recognized and the period over which it is expected to be recognized, as well as the total compensation cost capitalized as part of the cost of an asset (and thus recognizable in future years' income statements). Because that information should be readily available, the Board believes that the cost of disclosing it is not likely to exceed the related benefits.

B239. Some respondents said that certain of the minimum disclosures, such as the total amount of compensation cost, also should be required on a quarterly basis. The Board notes that paragraph 30 of APB Opinion No. 28, *Interim Financial Reporting,* specifies information to be included in quarterly financial reports, including information about changes in accounting principles or estimates and significant changes in financial position. The Board concluded that this Statement should not specify information about share-based compensation arrangements to be provided quarterly. Rather, entities should look to the general requirements of Opinion 28. The Board also notes that entities for which share-based compensation cost is significant may wish to provide additional information, including the total amount of that cost, on a quarterly basis to help users better understand their quarterly financial reports.

How the Fair Value of Goods or Services, Including Employee Services, Received as Consideration for Equity Instruments Issued Was Determined

B240. Another important objective of disclosures about share-based payment arrangements is to enable users of financial statements to understand how the fair value (or calculated value)[168] of the goods or services received, or the equity instruments issued, during the period was determined. This Statement requires that a public entity measure employee services received as consideration for equity instruments granted and

[168]A nonpublic entity for which it is not possible to reasonably estimate the fair value of its share options and similar instruments because it is not practicable to estimate the expected volatility of its share price is required to account for its equity share options and similar instruments based on a calculated value (paragraph 23). Disclosures applicable to those instruments also apply if a calculated value rather than fair value is used. For convenience, that point generally is not noted in the remainder of the discussion of disclosure requirements.

liabilities incurred in share-based payment transactions with employees based on the fair value of the instruments issued. However, if the fair value of goods or services received in a share-based payment transaction with nonemployees is more reliably measurable than the fair value of the equity instruments issued, the fair value of the goods or services received should be used to measure the transaction. To understand the effects of share-based payment arrangements on the financial statements, users need to understand how the related fair value amounts were determined.

B241. The minimum disclosures specified in paragraph A240(f) of this Statement as necessary to enable users to understand how fair values were determined also were required by Statement 123. However, because this Statement gives greater emphasis to lattice models than Statement 123 did, the required disclosures of the significant assumptions used to estimate the fair value of share-based compensation awards are revised to specifically encompass assumptions used in lattice models that employ a range of assumptions. For example, an entity that uses a valuation method in which different expected volatilities are used during the contractual term of an option is required to disclose the range of volatilities used.

B242. Some respondents to the Exposure Draft requested that the Board require disclosure of a sensitivity analysis of the effects of different assumptions about expected volatility and expected term. Paragraph A242 of this Statement indicates that an entity may wish to disclose additional information, such as a range of values calculated using different assumptions, if it believes that information would be useful to investors and creditors. However, the Board concluded that it is not necessary to require disclosure of such ranges or sensitivity analyses in all circumstances.

Information about Cash Flow Effects of Share-Based Payment Arrangements

B243. The Board concluded that an objective of the disclosures required by this Statement should be to provide information that enables users to understand the cash flow effects of share-based payment arrangements. The Board considers that objective to be consistent with the focus of users of financial statements on cash flows and with the overall financial reporting objective of providing information useful in assessing future cash flows.

B244. Although Statement 123 did not require the disclosures specified in paragraphs A240(i)–A240(k) of this Statement, entities likely disclosed certain of those items in the statement of cash flows if they were significant. Separate disclosure in the statement of cash flows of (a) the amount of cash received from exercise of share options and similar instruments and the related income tax benefits that were

recognized in equity and (b) the amount of cash used to settle equity instruments granted under share-based payment arrangements will satisfy the related disclosure requirements of this Statement.

B245. The Board considered also requiring disclosure of the cash used to repurchase shares in conjunction with share-based payment arrangements. However, an entity may repurchase its shares for various reasons, and the Board concluded that distinguishing between shares repurchased for share-based payment arrangements and shares repurchased for other reasons would not always be feasible. Accordingly, the Board decided instead to require a description of the entity's policy for repurchasing shares in conjunction with share-based payment arrangements if such a policy exists, and the number of shares, if any, expected to be repurchased for that purpose in the following annual reporting period.

EFFECTIVE DATES AND TRANSITION

Effective Dates

Public Entities That Are Not Small Business Issuers

B246. The Exposure Draft's proposed effective date was for new awards and awards modified or settled in fiscal years beginning after December 15, 2004. Many respondents said that more time would be needed to adopt this Statement, often citing the ongoing implementation with the Sarbanes-Oxley Act[169] as a constraint on available resources. Moreover, the effective date proposed in the Exposure Draft was predicated on a targeted issuance date for this Statement of no later than November 15, 2004. In light of those comments and the fact that this Statement is being issued later than projected, the Board concluded that the effective date of this Statement should be deferred beyond the date proposed in the Exposure Draft.

B247. The Board also understands that users of financial statements expressly desire that the improvements to accounting for share-based compensation made by this Statement be reflected in financial statements as soon as possible. Moreover, the Board does not consider it necessary to defer the effective date as long as a year after this Statement is issued, as some respondents requested. Public entities have for many years been either recognizing, or disclosing the pro forma effects of recognizing, compensation cost based on the fair value of awards to employees. Even though the

[169]Public Law 107-204—July 30, 2002, Section 180(b)(1)(A)(v).

fair-value-based method in this Statement differs in certain respects from the one in Statement 123, those differences are not sufficient to warrant an extended transition period for larger public entities. Accordingly, after weighing the expressed desires of users of financial statements against what it is reasonable to expect of the entities that prepare those financial statements, the Board concluded that, for public entities that do not file as small business issuers, this Statement should be effective for new awards and those modified, repurchased, or cancelled in interim or annual reporting periods beginning after June 15, 2005.

Small Business Issuers

B248. Certain respondents asked the Board to permit *small business issuers* to apply this Statement's measurement provisions for nonpublic entities. Entities that file as small business issuers are, by definition, public entities, and the Board concluded that those entities should apply the measurement requirements for public entities. Those entities should be able to apply the guidance in Appendix A to develop reasonable estimates of the fair value of their share options and similar instruments. However, the Board recognizes that small business issuers, like nonpublic entities, may have fewer resources than do larger public entities to devote to implementing new accounting standards and thus may need additional time to do so. The Board therefore concluded that entities that file as small business issuers should be permitted to defer adoption of this Statement until their first interim or annual reporting period beginning after December 15, 2005.

Nonpublic Entities

B249. As with small business issuers, the Board concluded that nonpublic entities should be permitted additional time to adopt this Statement. Therefore, the effective date for nonpublic entities is fiscal years beginning after December 15, 2005. Statement 123 permitted nonpublic entities to use the minimum value method to estimate the value of their employee share options and similar instruments, and most nonpublic entities thus have not previously been using a fair-value-based method for recognition or pro forma disclosure purposes. Because it omits expected volatility, an estimate based on minimum value is not comparable to one based on fair value. In addition, a nonpublic entity for which it is not practicable to estimate the expected volatility of its share price will need time to identify or develop an appropriate industry sector index to use in determining the calculated value required by this Statement. Accordingly, the Board concluded that nonpublic entities should be required to apply this Statement to new awards and to those modified, or settled (by means other than exercise or lapse) in fiscal years beginning after December 15, 2005.

Transition for Public Entities, Including Small Business Issuers

B250. The Board considered several alternatives for how public entities should accomplish the transition to this Statement, including full retrospective application with restatement of prior periods' financial statements, prospective application, and variations of each. The Board evaluated those alternatives in the context of the proposed requirements in its Exposure Draft of a proposed Statement, *Accounting Changes and Error Corrections,* which would replace Opinion 20 and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements.* That Exposure Draft was issued for comment on December 15, 2003, as part of the Board's international convergence project. Under the provisions of that proposed Statement, a change in accounting principle would be applied retrospectively unless it is impracticable to determine either the cumulative effect or the period-specific effects of the change. Retrospective application would be deemed impracticable if it would require significant estimates as of a prior period, and it would not be possible to objectively determine whether information used to develop those estimates would have been available at the time the affected transactions or events would have been recognized in the financial statements or whether that information arose subsequently.

B251. If full retrospective application with restatement were practicable, the Board believes it would be the best transition method for this Statement because retrospective application would provide the maximum amount of comparability between periods and thus enhance the usefulness of comparative financial statements. However, the Board concluded that full retrospective application of the change in accounting principle to adopt this Statement would be impracticable because it could require an entity to make estimates as of a prior period. Although the guidance in this Statement on estimating the fair value of an award at the grant date is similar to the guidance that public entities have been following for either recognition or pro forma disclosure purposes under Statement 123, this Statement clarifies and elaborates on Statement 123's guidance. As a result, an entity might conclude that some aspects of its estimation method used in prior years should be changed, which could call for estimates of, for example, employees' expected early exercise and post-vesting employment termination behavior as of earlier periods. Other requirements of this Statement, for example, the method of measuring the effects of a modification of an award, also differ from the related requirements of Statement 123 and could require estimates as of an earlier period. The Board thus rejected full retrospective application.

Modified Prospective Application

B252. For public entities and nonpublic entities that used the fair-value-based method for recognition or pro forma disclosures under Statement 123, the Board also rejected

full prospective application, that is, application only to new awards and to those modified or settled in fiscal periods beginning after the required effective date. Public entities have been for many years either recognizing or disclosing the pro forma effects of recognizing compensation cost from share-based payment arrangements with employees using a fair-value-based method that is similar to the method in this Statement. Accordingly, the Board concluded that all public entities and nonpublic entities that used the fair-value-based method for recognition or pro forma disclosures also should apply this Statement to the nonvested portion of awards granted before the required effective date and outstanding at the date of adoption. However, the grant-date fair value of those nonvested awards should not be adjusted for differences between the requirements of this Statement and those of Statement 123. That is, compensation cost for the nonvested portion of awards outstanding at the date of adoption should be recognized based on the previously estimated grant-date fair value and, except for the method of incorporating expected forfeitures before vesting, the same attribution method used for recognition or pro forma disclosures under Statement 123. Because previously estimated grant-date fair values will not be adjusted, modified prospective transition is practicable and will not impose significant costs. However, to enhance comparability, the Board concluded that entities that used the method permitted by Statement 123 of reflecting the effect of actual forfeitures of nonvested awards only as they occur should not continue to do so during the transition period. Thus, paragraph 80 of this Statement requires that an entity using that method adjust expected forfeitures as of the date of adoption.

Modified Retrospective Application

B253. The Exposure Draft would have precluded any form of retrospective application. Many respondents who addressed transition issues urged the Board to permit, if not require, a modified version of retrospective application in which the amounts used for prior periods presented would be the same as reported in the pro forma disclosures for those years. In reconsidering the transition alternatives in light of the comments received during the exposure period, the Board concluded that modified retrospective application should be permitted. As discussed in paragraph B252 of this Statement, using amounts previously reported in pro forma disclosures for prior years does not necessitate re-estimating fair values for those years and thus is neither impracticable nor costly to implement. However, regardless of whether this Statement is applied retrospectively as described, the pro forma amounts for prior years are available in the financial statements for those years. Thus, the Board concluded that modified retrospective application should not be required. Accordingly, this Statement permits all public entities and nonpublic entities that previously used the fair-value-based method in Statement 123 for either recognition or pro forma disclosures to choose between modified prospective or modified retrospective application.

Modified Retrospective Application Only to Beginning of Year of Adoption

B254. As noted in paragraph B247, the Board's balancing of the needs of users and preparers of financial statements resulted in an effective date of interim or annual periods beginning after June 15, 2005, for public entities that are not small business issuers. Thus, the effective date will fall in the middle of many public entities' fiscal years. The Board recognizes that some such entities may be concerned about the possible effects of a mid-year effective date on intra- and inter-year comparisons. Accordingly, the Board decided to permit an entity to choose to retrospectively apply this Statement (using the modified retrospective method) only to prior interim periods of the year of adoption.

Transition for Nonpublic Entities

B255. As noted in paragraph B249, one reason for providing a deferred effective date for nonpublic entities is that Statement 123 permitted those entities to use minimum value rather than fair value for recognition or pro forma disclosures. This Statement requires nonpublic entities that used the minimum value method under Statement 123 to adopt this Statement prospectively. Those entities have neither the grant-date fair value amounts for nonvested awards outstanding at the date of adoption of this Statement necessary for modified prospective transition nor the pro forma fair value disclosures for prior years necessary for modified retrospective application.

Transition Provisions for Awards for Which the Classification Changes from Equity to Liabilities

B256. Application of this Statement, combined with application of the classification provisions of Statement 150, may change the classification of a freestanding financial instrument granted to an employee from an equity instrument to a liability. The Board concluded that that change in classification should be made by recognizing a liability at its fair value (or portion thereof if the requisite service has not been rendered). If the fair value (or portion thereof) of the liability is greater than or less than previously recognized compensation cost for the instrument, the liability should be recognized, first, by reducing equity to the extent of such previously recognized cost, and second, by recognizing the difference in the income statement, net of any related tax effect, as the cumulative effect of a change in accounting principle. The Board does not consider it appropriate to continue to classify as equity an instrument that qualifies as a liability under this Statement. However, the Board also does not consider full retrospective application of changes in classification to be practicable because that transition method would require estimates of the fair value of the reclassified instruments for earlier

periods. The Board thus concluded that reclassification of such instruments according to the transition guidance in this Statement is the best available alternative.

Effective Date and Transition Provisions for Nonpublic Entities That Become Public Entities after June 15, 2005

B257. Some constituents asked the Board to clarify the effective date and transition requirements for nonpublic entities that become public entities after June 15, 2005. That clarification is provided in paragraphs 69, 74, 76, and 83. In essence, those paragraphs indicate that a newly public entity should apply whatever provisions are applicable to its new status as of the beginning of the first interim or annual period after it becomes a public entity, taking into account whether it used the fair-value-based method or the minimum value method for recognition or pro forma disclosures under Statement 123. For example, paragraph 69 provides that the effective date for a nonpublic entity that becomes a public entity after June 15, 2005, and does not file as a small business issuer is the first interim or annual reporting period beginning after the entity becomes a public entity. If the newly public entity files as a small business issuer, the effective date is the first interim or annual reporting period beginning after December 15, 2005, for which the entity is a public entity.

CONVERGENCE OF U.S. AND INTERNATIONAL ACCOUNTING STANDARDS ON ACCOUNTING FOR SHARE-BASED PAYMENT TRANSACTIONS

B258. One potential benefit of this project is the opportunity for increased convergence of U.S. and international accounting standards on accounting for share-based payment transactions. At the time the Board added the project to its agenda early in 2003, the comment period on the IASB's ED2 was nearing its end, and the IASB was preparing to redeliberate its conclusions based on the comments received. Although the FASB's and the IASB's projects were at different stages (the FASB was working toward an Exposure Draft at the same time the IASB was working toward a final standard), both Boards considered it appropriate to cooperate to the extent feasible in considering the issues. Although the two Boards conducted their projects separately, the objective was to work together in understanding the issues and alternatives, with the objective of reaching compatible conclusions and thus furthering convergence of U.S. and international accounting standards on share-based payment. To a large extent, that objective was achieved. Accounting for share-based payment arrangements under this Statement and related accounting under IFRS 2 have the potential to differ in only a few areas. Those differences may be further reduced as the FASB progresses with the next phase of its project on accounting for share-based payment arrangements (refer to

paragraphs B12–B14) as well as other convergence projects. In addition, the two Boards will consider whether to undertake additional work to further converge their respective accounting standards on share-based payment when the FASB has completed its project on accounting for share-based payment arrangements and its current project on distinguishing between liabilities and equity.

B259. The more significant differences between this Statement and IFRS 2 are:

a. Accounting for share-based payment arrangements with other than employees
b. Determining whether an employee share purchase plan gives rise to compensation cost
c. Measurement of share options granted by a nonpublic entity
d. Accounting for certain types of modifications of awards
e. Classification of certain instruments as liabilities or equity
f. Certain aspects of accounting for the income tax effects of an award of equity instruments.

Difference between Scope of This Statement and Scope of IFRS 2

B260. The Board's decision not to reconsider the existing guidance for share-based payment arrangements with nonemployees in developing this Statement may result, at least temporarily, in different accounting for those arrangements under U.S. GAAP and IFRS 2. The scope of IFRS 2 includes accounting for all share-based payment arrangements, regardless of whether the counterparty is an employee. All of those arrangements generally will be accounted for using the modified grant-date method that this Statement requires for share-based payment transactions with employees. In contrast, Issue 96-18 requires that grants of share options and other equity instruments to nonemployees be measured at the earlier of (a) the date at which a commitment for performance by the counterparty to earn the equity instruments is reached or (b) the date at which the counterparty's performance is complete. For many awards, the measurement date under Issue 96-18 will differ from the measurement date prescribed by IFRS 2, with a resulting difference in the amount of cost recognized for those awards.

Employee Share Purchase Plans

B261. For the reasons discussed in paragraphs B112–B116, this Statement retains the original Statement 123 criteria for determining whether an employee share purchase plan is compensatory or not. IFRS 2 contains more stringent criteria that are essentially the same as those proposed in the FASB's Exposure Draft. The result of that difference is that some employee share purchase plans for which IFRS 2 requires recognition of

compensation cost will not be considered to give rise to compensation cost under this Statement. An example is a plan that provides a 5 percent discount to employees that is not extended to other holders of the same class of shares. However, this Statement also includes an alternative criterion, which is essentially the same as the one in IFRS 2. Thus, if it so chooses, an entity generally would be able to satisfy both the requirements of this Statement and those of IFRS 2 in determining whether an employee share purchase plan is considered to be compensatory.

Equity Share Options Granted by a Nonpublic Entity

B262. IFRS 2 applies the same measurement requirements to employee share options regardless of whether the issuer is a public or a nonpublic entity. IFRS 2 contains the same accounting treatment as this Statement for financial instruments granted under share-based payment arrangements if the entity concludes that fair value cannot be reasonably estimated at the grant date. The IASB noted that share options granted by a nonpublic (or newly public) entity may fall into that category.

B263. This Statement requires that a nonpublic entity account for its options and similar equity instruments based on their fair value unless it is not practicable to estimate the expected volatility of the entity's share price. In that situation, the entity is required to measure its equity share options and similar instruments at a value calculated by substituting the historical volatility of an appropriate industry sector index for the expected volatility of its share price in applying an option-pricing-model.

Type III Modifications

B264. As indicated in paragraphs B192 and B193, the requirements of this Statement on accounting for Type III modifications differ from the related requirements of IFRS 2, which treat such modifications as affecting only the number of instruments that are likely to vest.

Distinguishing between Liabilities and Equity

B265. Currently, U.S. and international accounting guidance differ on various aspects of distinguishing between liabilities and equity and accounting for financial instruments with characteristics of both, and the FASB has an active project to reconsider portions of that guidance. In the meantime, related aspects of accounting for certain financial instruments issued to employees as compensation may differ under this Statement and under IFRS 2. For example, IFRS 2 does not distinguish between liabilities and equity using all the criteria established in Statement 150.

B266. This Statement does not attempt to analyze all potential differences between this Statement and IFRS 2 that stem from different U.S. and international accounting standards on liabilities and equity because at least some of those differences may be resolved when the FASB completes its project on that topic. As noted in paragraph B258, the FASB and the IASB will consider undertaking a joint project at that time to resolve any remaining differences between their standards on share-based payment.

Income Tax Effects of Equity Instruments Awarded to Employees

B267. The FASB's conclusion that the total tax deduction for an award of equity instruments arises from two transactions or events (paragraph B209) is consistent with the requirements of IFRS 2. However, the FASB and the IASB reached different conclusions on certain aspects of accounting for the income tax effects of equity instruments awarded to employees.

B268. In tax jurisdictions such as the United States, where the time value of share options generally is not deductible for tax purposes, IFRS 2 requires that no deferred tax asset be recognized for the compensation cost related to the time value component of the fair value of an award. A deferred tax asset is recognized only if and when the share options have intrinsic value that could be deductible for tax purposes. Therefore, an entity that grants an at-the-money share option to an employee in exchange for services would not recognize tax effects until that award was in-the-money. In contrast, this Statement requires recognition of a deferred tax asset based on the grant-date fair value of the award. The effects of subsequent decreases in the share price (or lack of an increase) are not reflected in accounting for the deferred tax asset until the related compensation cost is recognized for tax purposes. The effects of subsequent increases that generate excess tax benefits are recognized when they affect taxes payable.

B269. This Statement requires a portfolio approach in determining excess tax benefits of equity awards in paid-in capital available to offset write-offs of deferred tax assets, whereas IFRS 2 requires an individual instrument approach. Thus, some write-offs of deferred tax assets that will be recognized in paid-in capital under this Statement will be recognized in determining net income under IFRS 2.

COST-BENEFIT CONSIDERATIONS

B270. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the

Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, investors and creditors—both present and potential—and other users of financial information benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy. However, the value of that incremental improvement to financial reporting and most of the costs to achieve it are subjective and cannot be quantified.

B271. The Board's consideration of each issue in a project includes the subjective weighing of the incremental improvement in financial reporting against the incremental cost of implementing the identified alternatives. At the end of that process, the Board considers the accounting provisions in the aggregate and assesses the related perceived costs on a qualitative basis.

B272. Several procedures were conducted before the issuance of the Exposure Draft to aid the Board in assessing the expected costs associated with implementing the required use of the fair-value-based accounting method. Those procedures included a field visit program, a survey of commercial software providers, and discussions with Option Valuation Group members and other valuation experts. In addition, the Board discussed this Statement's provisions with the Financial Accounting Standards Advisory Council, the User Advisory Council, the Small Business Advisory Committee, as well as with numerous constituents at four public roundtable meetings and at various other meetings.

B273. The Board uses the term *field test* to describe a formal application of a proposed Statement by a group of entities to their individual situations. The participating entities are provided with a description of the proposed approach (if an Exposure Draft has not yet been issued) and are asked to apply that approach either to current transactions or retroactively to one or more prior years. A field test may involve having the participating entities prepare financial statements in accordance with a proposed approach to accounting for a particular type of transaction. Field tests involve a significant commitment of resources by the participating entities—a commitment that the Board asks for only if it concludes that it cannot obtain the information it needs through field visits or other means. The Board conducted field tests in its deliberations that led to Statement 123 (paragraph C11 of this Statement).

B274. The Board uses the term *field visit,* on the other hand, to describe meetings with companies or firms to discuss a possible change in the accounting for a transaction, such as a share-based payment transaction. A field visit involves Board and staff

members' meeting with individual entities at their offices or by means of a conference call to engage in an in-depth discussion of a proposed Statement. Entities participating in a field visit program are provided with a draft of the proposed requirements, together with a list of discussion questions. The questions focus on helping the Board and staff to better understand the costs and benefits of changing to the proposed approach, the operationality of the proposed approach, and any difficulties an entity might face in applying it.

B275. The Board concluded for its current project that field visits were an appropriate means of gathering information about the perceived costs of the proposed changes to Statement 123. The Board believes that field tests are more important for a proposed standard that would require an entirely new method of accounting, such as the original Statement 123, and, as mentioned in paragraph B273, field tests were conducted before issuance of Statement 123. That is not the situation with this Statement, which improves the fair-value-based method in Statement 123 rather than requiring an entirely new accounting method. Further, thousands of public entities have had many years of experience in estimating the fair values of their awards of share-based employee compensation—estimates that Statement 123 required for either recognition or pro forma disclosure purposes.

B276. The field visit program included discussions with 18 enterprises selected to achieve broad coverage of constituent enterprises based on market capitalization, software used to value employee share options, filing status (public or nonpublic), industry membership, total number of employees, total awards outstanding, and types of awards outstanding. Field visit participants included preparers of financial statements, employee benefit consultants, and auditors. Before each field visit, participants received a package of materials, including a description of the proposed changes to Statement 123, a discussion of the type of information that could be incorporated into a lattice model, and questions for participants to consider.

B277. The Board also solicited information by means of a questionnaire survey of commercial software providers about the functionality of existing tracking and valuation software for employee share options and similar instruments. That survey asked about the functionality of existing software used to track grants of share-based compensation and to estimate the fair value of the related instruments. The survey also asked about the estimated costs and timing of availability of software with the ability to estimate fair value using a lattice model that incorporated information about employees' expected early exercise and post-vesting employment termination behavior.

B278. After comments were received on the Exposure Draft, the Board undertook additional cost-benefit procedures for nonpublic entities. Interviews were conducted with 13 constituents, selected to provide broad coverage of concerns related to nonpublic entities. The interviews covered detailed questions included in a questionnaire provided to interviewees before the date of the interviews. Questions covered included the types of share-based compensation used by nonpublic entities, how frequently awards are granted, how the current price of a nonpublic entity's share price is determined in complying with Opinion 25 and Statement 123, and the ways in which nonpublic entities might obtain information needed to apply the fair-value-based method, including likely costs that would be incurred to do so. In addition, cost-benefit issues were discussed at a meeting of the Small Business Advisory Committee held in May 2004.

B279. Based on the findings of the cost-benefit procedures, the Board concluded that this Statement will sufficiently improve financial reporting to justify the costs it will impose. Most of the expected benefits of required recognition of the cost of share-based compensation arrangements with employees using the fair-value-based method have been discussed already. In addition, existing guidance on accounting for share-based employee compensation is simplified because this Statement eliminates Opinion 25 and the guidance necessary to implement it (except for certain awards granted by nonpublic entities before the effective date of this Statement).

B280. Several of the Board's decisions are intended to mitigate the incremental costs of complying with this Statement. For example, an alternative measurement method based on substituting the historical volatility of an appropriate industry sector index for expected volatility (calculated value) also is provided for equity options and similar instruments granted by a nonpublic entity if it is not practicable to estimate the expected volatility of its share price. As a result, such nonpublic entities will incur minimal incremental costs in addition to those necessary to comply with the minimum value method in Statement 123. In addition, a nonpublic entity is not required to estimate the fair value (or calculated value) of its liability awards; instead, such an entity may elect to account for its liabilities based on their intrinsic value. Transition costs for public entities have been minimized by requiring that compensation cost for the nonvested portion of awards granted before the issuance of this Statement be based on the grant-date fair values previously estimated for recognition or pro forma disclosure purposes under Statement 123.

Appendix C

BACKGROUND INFORMATION

C1. APB Opinion No. 25, *Accounting for Stock Issued to Employees,* was issued in 1972. Opinion 25 required that compensation cost for an award of equity share options be measured at its intrinsic value, which is the amount by which the fair value of the underlying equity share exceeds the exercise price. Opinion 25 also established criteria for determining the date at which an award's intrinsic value should be measured; those criteria distinguished between awards whose terms are known (or fixed) at the date of grant and awards whose terms are not known (or variable) at the date of grant. Measuring the intrinsic values of fixed awards at the grant date generally resulted in little or no compensation cost being recognized for valuable equity instruments given to employees in exchange for their services. Additionally, distinguishing between fixed and variable awards was difficult in practice, which resulted in a large amount of specialized and complex accounting guidance.

C2. In 1984, the Board added to its agenda a project to reconsider Opinion 25. On May 31, 1984, an FASB Invitation to Comment, *Accounting for Compensation Plans Involving Certain Rights Granted to Employees,* was issued based on the November 4, 1982, AICPA Issues Paper, *Accounting for Employee Capital Accumulation Plans*. The Board received 144 letters of comment.

C3. The issues raised in that Invitation to Comment were complex and highly controversial. Still, each time the issue was raised, Board members voted unanimously that employee share options result in compensation cost that should be recognized in the employer's financial statements.

C4. As with all FASB projects, the Board's discussions of stock compensation were open to public observations, and its tentative conclusions on individual issues were reported in its weekly *Action Alert*. During the Board's deliberations from 1985 to 1988, more than 200 letters were received that commented on, and usually objected to, tentative conclusions reported in *Action Alert*.

C5. Some Board members and others were troubled by the differing results of stock-based compensation plans that called for settlement in cash and those that called for settlement in stock. But exercise date accounting for all plans is the only way to achieve consistent results between cash and stock plans, and that accounting was not

considered to be consistent with the definitions of liabilities and equity in FASB Concepts Statement No. 6, *Elements of Financial Statements*. It also would be inconsistent with current accounting for stock purchase warrants, which are similar to employee share options except that warrants are issued to outsiders rather than to employees.

C6. Part of the financial instruments project on the Board's agenda considers whether changes to the concepts of liabilities and equity are needed. Late in 1988, the Board decided to set aside specific work on stock compensation while it considered broader questions of how to distinguish between liabilities and equity and the implications of that distinction.

C7. In August 1990, an FASB Discussion Memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both,* was issued. The Discussion Memorandum framed and discussed numerous issues, some of which directly related to how to account for employee share options. The Board received 104 comment letters and in March 1991 held a public hearing on those issues, at which 14 commentators appeared.

C8. More than 90 percent of the respondents to the Discussion Memorandum said that an entity's obligation to issue its own stock is an equity instrument because the entity does not have an obligation to transfer assets (an equity's own stock is not an asset), which is an essential characteristic of a liability. In February 1992, the Board decided not to pursue possible changes to the conceptual distinction between liabilities and equity and to resume work on the stock compensation project within the present conceptual framework.

C9. In March 1992, the Board met with several compensation consultants and accountants to discuss current practice in valuing employee share options and accounting for stock compensation. The compensation consultants generally agreed that current accounting provisions heavily affected the design of stock compensation plans. They said that there were far fewer variable (or performance) plans than fixed plans because of the required accounting for variable plans. The compensation consultants also said that the Black-Scholes-Merton formula and other option-pricing models were used to value various types of employee share options for purposes other than accounting. Grant date measures were relied on to provide comparisons to other compensation arrangements.

C10. A task force of accountants, compensation consultants, industry representatives, and academics was formed to assist in the project. Accounting for stock compensation was addressed at 19 public Board meetings and at 2 public task force meetings in 1992

and 1993. The Board's tentative conclusions on individual issues were reported in *Action Alert*. During 1992 and the first part of 1993, more than 450 comment letters were received, mostly objecting to the tentative conclusions. Many of the letters proposed disclosure in lieu of cost recognition for stock compensation. Several of the commentators submitted alternatives to the Board; the most comprehensive disclosure proposal was included as an appendix to the FASB Exposure Draft, *Accounting for Stock-Based Compensation,* issued in June 1993.

C11. The 1993 Exposure Draft would have required recognizing compensation cost for all awards of stock-based compensation that eventually vest, based on their fair value at the grant date. The Board and KPMG Peat Marwick conducted a field test of the provisions of the 1993 Exposure Draft. In addition, other organizations provided information about their own test applications of the 1993 Exposure Draft.

C12. The 1993 Exposure Draft was extraordinarily controversial; the Board received 1,789 comment letters. The vast majority of respondents objected to the recognition of compensation cost for fixed employee share options—sometimes for reasons that had little to do with accounting. In March 1994, the Board held six days of public hearings in California and Connecticut. Representatives from 73 organizations presented testimony at those hearings. Several legislative proposals were introduced in Congress, both opposing and supporting proposals in the 1993 Exposure Draft. A Sense of the Senate resolution was passed that the FASB "should not at this time change the current generally accepted accounting treatment of stock options and stock purchase plans." However, a second resolution was passed that "Congress should not impair the objectivity or integrity of the FASB's decision making process by legislating accounting rules."

C13. In April 1994, the Board held a public roundtable discussion with academic researchers and other participants on proposals the participants had submitted to improve the measure of the value of share options. Also during 1994, the Board discussed accounting for stock-based compensation at 13 public Board meetings and at 1 public task force meeting.

C14. In December 1994, the Board discussed the alternatives for proceeding with the project on accounting for stock-based compensation in light of the comment letters, public hearing testimony, and various meetings held to discuss the project. The Board decided to encourage, rather than require, recognition of compensation cost based on a fair-value-based method and to pursue expanded disclosures. Employers would be permitted to continue to apply the provisions of Opinion 25. Employers that continued

to apply Opinion 25 would be required to disclose the pro forma effects on net income and earnings per share as if the new fair-value-based accounting method had been applied.

C15. The Board discussed the details of the disclosure-based approach at six public Board meetings in 1995. In 1995, 131 comment letters were received on the disclosure-based approach. In May 1995, an initial draft of the standards sections and some other parts of Statement 123 were distributed to task force members and other interested parties that requested the draft; 34 comments letters were received.

C16. Statement 123 was issued in October 1995 and was effective for share-based compensation transactions entered into in fiscal years that began after December 15, 1995. As originally issued, Statement 123 established a fair-value-based method of accounting for share-based compensation awarded to employees. The fair-value-based method of accounting requires that compensation cost for awards of share options be measured at their fair value on the date of grant. As opposed to the accounting under Opinion 25, the application of the fair-value-based method to fixed awards results in compensation cost being recognized when services are received in exchange for equity instruments of the employer. Statement 123 established as preferable the fair-value-based method and encouraged, but did not require, entities to adopt it. The Board's decision at that time to permit entities to continue accounting for share-based compensation transactions using Opinion 25 was based on practical rather than conceptual considerations.

C17. In the years following the issuance of Statement 123, users of financial statements, including institutional and individual investors, as well as many other parties expressed to the FASB their concerns that using Opinion 25's intrinsic value method results in financial statements that do not faithfully represent the economic transactions affecting the issuer, namely, the receipt and consumption of employee services in exchange for equity instruments.

C18. Beginning in 2002, a number of public companies began to adopt Statement 123's fair-value-based method of accounting. In connection with those decisions, a number of companies, as well as financial statement users, expressed concerns to the Board about the lack of comparability and consistency of reported results between periods caused by the ramp-up effect inherent in Statement 123's requirement to adopt the fair-value-based method prospectively. Such concerns led the Board to undertake a limited-scope project to reconsider the transition and disclosure provisions of Statement 123; that project resulted in the issuance of FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure,* in December 2002.

C19. In November 2002, shortly after the IASB issued a proposed IFRS, *Share-based Payment*, the FASB issued an 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. The Invitation to Comment explained both similarities of and differences between the requirements of Statement 123 and the method proposed by the IASB. The Board received 302 letters of comment in response to the Invitation to Comment, many of which commented only on the issue of whether the FASB should require recognition at fair value of compensation cost for employee share options. Most users of financial statements who responded to the Invitation to Comment urged the Board to undertake a project to require that entities account for share-based payment arrangements with employees using a fair-value-based method. The majority of the preparers who responded did not support such a requirement. However, some of those preparers asked for additional guidance on applying the fair-value-based method in Statement 123.

C20. In response to concerns about impaired usefulness, and a lack of transparency, of financial reporting resulting from the continued use of Opinion 25, and consistent with its commitment to the convergence of international accounting standards, the Board added a project to its agenda in March 2003 to reconsider Statement 123. Shortly after adding this project to its agenda, the Board established an Option Valuation Group to provide information and advice on how to improve the guidance in Statement 123 on measuring the fair value of share options and similar instruments issued to employees in compensation arrangements. That group included valuation experts from the compensation consulting, risk management, investment banking, and academic communities. The Board and staff met formally with that group and consulted frequently with its members.

C21. The Board deliberated issues in Statement 123, including the information received in the letters of comment on the Invitation to Comment, at 39 public meetings from March 2003 through March 2004. One of those meetings, held in October 2003, was a joint meeting of the FASB and the IASB. Additionally, the Board received 134 unsolicited letters of comment from various constituents during the deliberative process leading to the Exposure Draft that led to this Statement. Those respondents commented on various aspects of share-based payment and this project.

C22. During the fourth quarter of 2003, the Board conducted field visits related to the Exposure Draft that led to this Statement with various enterprises selected to achieve a broad coverage of constituent enterprises. Field visit participants included preparers of financial statements, employee benefit consultants, and auditors. Other cost-benefit procedures were performed and are described in paragraphs B270–B280.

C23. On March 31, 2004, the Board issued an FASB Exposure Draft, *Share-Based Payment,* with a comment period ending in June 2004. The Board received 14,239 comment letters in response to the 2004 Exposure Draft. In June 2004, the Board held four public roundtable meetings in California and Connecticut. Representatives from 73 organizations participated in those meetings.

C24. During the 108th Congress, several legislative proposals were introduced relating to the accounting for employee share options. On July 20, 2004, the United States House of Representatives passed H.R. 3574, the "Stock Option Accounting Reform Act." The Act's provisions prescribed detailed accounting guidance to be followed only for the chief executive officer and four other most highly compensated employees. On September 7, 2004, H.R. 3574 was referred to the Committee on Banking, Housing, and Urban Affairs of the United States Senate. The United States Senate did not take any action on H.R. 3574 or a similar companion bill, S. 1890, the "Stock Option Accounting Reform Act," before the adjournment of the 108th Congress.

C25. In May 2004, the FASB Small Business Advisory Committee met in Connecticut to discuss, among other things, matters related to the accounting for share-based compensation. During that meeting, committee members indicated that only a small percentage of small businesses issue share options, but they noted that behavior changes if the business plans to have an initial public offering. In August 2004, the Board undertook additional cost-benefit procedures to obtain additional information related to the concerns of small businesses. Interviews were conducted with various constituents, selected to provide a broad coverage of concerns related to small businesses. Board members also met in both private and public sessions with representatives of small businesses, including the National Venture Capital Association and the AICPA's Technical Issues Committee.

C26. The Board redeliberated the issues in the 2004 Exposure Draft at 21 public meetings from August 2004 through December 2004. Appendix B discusses the basis for the Board's conclusions.

Appendix D

AMENDMENTS TO EXISTING PRONOUNCEMENTS

Amendments Made by Statement 123 Carried Forward in This Statement with Minor Changes

D1. FASB Technical Bulletin No. 82-2, *Accounting for the Conversion of Stock Options into Incentive Stock Options as a Result of the Economic Recovery Tax Act of 1981,* is superseded.

D2. FASB Statement No. 5, *Accounting for Contingencies,* is amended as follows: [Added text is underscored and deleted text is struck out.]

a. Paragraph 7:

> This Statement supersedes both *ARB No. 50* and Chapter 6, "Contingency Reserves," of *ARB No. 43.* The condition for accrual of loss contingencies in paragraph 8 of this Statement do not amend any other present requirement in an Accounting Research Bulletin or Opinion of the Accounting Principles Board to accrue a particular type of loss or expense. Thus, for example, deferred compensation contracts and stock issued to employees are excluded from the scope of this Statement. Those matters are covered, respectively, in *APB Opinion No. 12,* "Omnibus Opinion—1967," paragraphs 6–8, and ~~*APB Opinion No. 25,* "Accounting for Stock Issued to Employees"~~FASB Statement No. 123 (revised 2004), *Share-Based Payment.* Accounting for other employment-related costs is also excluded from the scope of this Statement except for postemployment benefits that become subject to this Statement through application of FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits.*

D3. FASB Statement No. 43, *Accounting for Compensated Absences,* is amended as follows:

a. Paragraph 2(d), as amended by FASB Statement No 112, *Employers' Accounting for Postemployment Benefits:*

> Stock compensation plans that are addressed by ~~APB Opinion No. 25, "Accounting for Stock Issued to Employees"~~FASB Statement No. 123 (revised 2004), *Share-Based Payment.*

D4. FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* is amended as follows:

a. Paragraph 8(a), as amended by Statement 112:

> Employers' and plans' obligations for pension benefits, other postretirement benefits including health care and life insurance benefits, postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements, as defined in FASB Statements No. 35, *Accounting and Reporting by Defined Benefit Pension Plans,* No. 87, *Employers' Accounting for Pensions,* No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* No. 112, *Employers' Accounting for Postemployment Benefits,* No. 123 (revised 2004), *Share-Based Payment,* and No. 43, *Accounting for Compensation Absences,* and ~~APB Opinions No. 25, *Accounting for Stock Issued to Employees,* and No. 12~~APB Opinion No. 12, *Omnibus Opinion—1967.*

D5. FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits,* is amended as follows:

a. Paragraph 5(d):

> Stock compensation plans that are addressed by ~~APB Opinion No. 25, *Accounting for Stock Issued to Employees*~~FASB Statement No. 123 (revised 2004), Share-Based Payment.

Amendments to Existing Pronouncements

D6. This Statement replaces FASB Statement No. 123, *Accounting for Stock-Based Compensation.*

D7. This Statement supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and the following related interpretations of Opinion 25:

a. AICPA Accounting Interpretation 1 of APB Opinion No. 25
b. FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*
c. FASB Interpretation No. 38, *Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock*

d. FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation.*

D8. This Statement supersedes FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure.*

D9. All references to FASB Statement No. 123, *Accounting for Stock-Based Compensation,* are replaced by *FASB Statement No. 123 (revised 2004), Share-Based Payment.* All references to Statement 123 are replaced by *Statement 123(R).*

D10. This Statement supersedes ARB No. 43, Chapter 13B, "Compensation Involved in Stock Option and Stock Purchase Plans."

D11. APB Opinion No. 28, *Interim Financial Reporting,* is amended as follows:

a. Paragraph 30(j) and its related footnote 8, added by Statement 148:

> ~~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[8]~~
> ~~(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.~~
>
> ---
>
> [8]~~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.*~~

D12. APB Opinion No. 29, *Accounting for Nonmonetary Transactions,* is amended as follows:

a. Footnote 4, as amended by Statement 123:

> FASB Statement No. 123 (revised 2004), ~~*Accounting for Stock-Based Compensation*~~*Share-Based Payment,* applies to all transactions in which an entity acquires goods or services by issuing its shares or other equity instruments (except for equity instruments held by an employee stock ownership plan) or by incurring liabilities to the supplier (a) in amounts based, at least in part, on the price of the entity's ~~common stock~~shares or other equity instruments~~.~~ or (b) that require or may require settlement by issuance of the entity's shares or other equity instruments.

D13. FASB Statement No. 109, *Accounting for Income Taxes,* is amended as follows:

a. Paragraph 36(e), as amended by Statement 123:

> Expenses for employee ~~stock~~share options recognized differently for financial reporting and tax purposes (refer to paragraphs ~~41–44~~58–63 of FASB Statement No. 123 (revised 2004), ~~*Accounting for Stock-Based Compensation*~~*Share-Based Payment* ~~and paragraph 17 of APB Opinion No. 25, *Accounting for Stock Issued to Employees*~~).

D14. FASB Statement No. 128, *Earnings per Share,* is amended as follows:

a. Paragraph 20, the heading preceding it, and its related footnote 12:

> ***~~Stock-based compensation arrangements~~Share-based payment arrangements***
>
> ~~Fixed awards and nonvested stock~~Awards of share options and nonvested shares (as defined in FASB Statement No. 123 (revised 2004), ~~*Accounting for Stock-Based Compensation*~~*Share-Based Payment*) to be issued to an employee[12] under a ~~stock~~share-based compensation arrangement are considered options for purposes of computing diluted EPS. Such ~~stock~~share-based awards shall be considered to be outstanding as of the grant date for purposes of computing diluted EPS even though their exercise may be contingent upon vesting. Those ~~stock~~share-based awards are included in the diluted EPS computation even if the employee may not receive (or be able to sell) the stock until some future date. Accordingly, all shares to be issued shall be included in computing diluted EPS if the effect is dilutive. The dilutive effect of ~~stock~~share-based compensation

arrangements shall be computed using the treasury stock method. If the equity share options or other equity instruments are outstanding for only part of a ~~stock based awards were granted during the~~ period, the shares issuable shall ~~must~~ be weighted to reflect the portion of the period during which the equity instruments ~~awards~~ were outstanding.

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[12]The provisions in paragraphs 20–23 also apply to ~~stock~~share-based awards issued to other than employees in exchange for goods and services.

b. Paragraph 21 and its related footnote 13:

In applying the treasury stock method described in paragraph 17, the assumed proceeds shall be the sum of (a) the amount, if any, the employee must pay upon exercise, (b) the amount of compensation cost attributed to future services and not yet recognized,[13] and (c) the amount of excess tax benefits ~~(both deferred and current)~~, if any, that would be credited to additional paid-in capital assuming exercise of the options. Assumed proceeds shall not include compensation ascribed to past services. The excess tax benefit is the amount resulting from a tax deduction for compensation in excess of compensation expense recognized for financial reporting purposes. That deduction arises from an increase in the market price of the stock under option between the measurement date and the date at which the compensation deduction for income tax purposes is determinable. The amount of the tax benefit shall be determined by a "with-and-without" computation. Paragraph 63 of Statement 123(R) states that the amount deductible on an employer's tax return may be less than the cumulative compensation cost recognized for financial reporting purposes. If the deferred tax asset related to that resulting difference would be deducted from additional paid-in capital (or its equivalent) pursuant to that paragraph assuming exercise of the options, that amount shall be treated as a reduction of assumed proceeds.~~Paragraph 17 of APB Opinion No. 25, *Accounting for Stock Issued to Employees,* states that in some instances the tax deduction for compensation may be less than the compensation expense recognized for financial reporting purposes. If the resulting difference in income tax will be deducted from capital in accordance with that paragraph, such taxes to be deducted from capital shall be treated as a reduction of assumed proceeds.~~

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[13]This provision applies only to those ~~stock~~share-based awards for which compensation cost will be recognized in the financial statements in accordance with ~~APB Opinion No. 25, *Accounting for Stock Issued to Employees,* or~~ Statement 123(R).

c. Paragraph 23:

> Awards with a market condition, a ~~P~~performance condition, or any combination thereof ~~awards~~ (as defined in Statement 123(R)) shall be included in diluted EPS pursuant to the contingent share provisions in paragraphs 30–35 of this Statement. ~~As discussed in paragraph 26 of Statement 123, targeted stock price options are not considered to be a performance award. However, because options with a target stock price have a market price contingency, the contingent share provisions of this Statement shall be applied in determining whether those options are included in the computation of diluted EPS.~~

d. Illustration 8—"Application of the Treasury Stock Method for Stock Appreciation Rights and Other Variable Stock Option Award Plans," paragraphs 157–159, is deleted because the accounting illustrated is based on Opinion 25 and its related interpretations, which are superseded by this Statement, and replaced with the following illustration:

> **Illustration 8—Application of the Treasury Stock Method to a Share-Based Payment Arrangement**
>
> 157. Under this Statement options to be settled in stock are potential common shares for purposes of earnings per share computations. In applying the treasury stock method, all dilutive potential common shares, regardless of whether they are exercisable, are treated as if they had been exercised. The treasury stock method assumes that the proceeds upon exercise are used to repurchase the entity's stock, reducing the number of shares to be added to outstanding common stock in computing earnings per share. The proceeds assumed to be received upon exercise include the exercise price that the employee pays, the amount of compensation cost measured and attributed to future services but not yet recognized, and the amount of any tax benefits upon assumed exercise that would be credited to additional paid-in-capital. If the deferred tax asset related to that resulting difference would be deducted from additional paid-in capital (or its equivalent) assuming exercise of the options, that amount shall be treated as a reduction of assumed proceeds.
>
> 158. Under paragraph 43 of Statement 123(R), the effect of forfeitures is taken into account by recognizing compensation cost only for those instruments for which the requisite service has been rendered, and no compensation cost is recognized for instruments that employees forfeit because a service condition or a performance condition is not satisfied. The following example illustrates the application of the treasury stock method when share options are forfeited.

159. Entity L adopted a share option plan on January 1, 20X7, and granted 900,000 at-the-money share options with an exercise price of $30.[a] All share options vest at the end of three years (cliff vesting). At the grant date, Entity L assumes an annual forfeiture rate of 3 percent and therefore expects to receive the requisite service for 821,406 [900,000 × (.97^3)] share options. On January 1, 20X7, the fair value of each share option granted is $14.69. Employees forfeited 15,000 stock options ratably during 20X7. The average stock price during 20X7 is $44. Net income for the period is $97,385,602 (inclusive of $2,614,398 of share-based compensation, net of income taxes of $1,407,753). Entity L's tax rate is 35 percent. For the year ended December 31, 20X7, there are 25,000,000 weighted-average common shares outstanding. Entity L has sufficient previously recognized excess tax benefits in additional paid-in capital from prior share-based payment arrangements to offset any write-off of deferred tax assets associated with its grant of share options on January 1, 20X7. All share options are the type that upon exercise give rise to deductible compensation cost for income tax purposes.

Computation of Basic EPS for the Year Ended December 31, 20X7:

Net income[b]	$ 97,385,602
Weighted-average common shares outstanding	25,000,000
Basic earnings per share	$ 3.90

Computation of assumed proceeds for diluted earnings per share:

Amount employees would pay if the weighted-average number of options outstanding were exercised using the average exercise price (892,500[c] × $30)	$ 26,775,000
Average unrecognized compensation cost in 20X7 (see computation)	10,944,050
Tax benefit deficiency that would be offset in paid-in capital (see computation)	(215,539)
Assumed proceeds	$ 37,503,511

Computation of average unrecognized compensation cost in 20X7:

Beginning of period

Unrecognized compensation cost (900,000 × $14.69)	$ 13,221,000

End of the period

Beginning of period	$ 13,221,000	
Annual compensation cost recognized during 20X7, based on estimated forfeitures	(4,022,151)[b]	
Annual compensation cost not recognized during the period related to outstanding options at December 31, 20X7, for which the requisite service is not expected to be rendered	(311,399)[d]	
Total compensation cost of actual forfeited options	(220,350)[e]	
Total unrecognized compensation cost, end of the period, based on actual forfeitures		8,667,100
Subtotal		21,888,100
Average total unrecognized compensation, based on actual forfeitures		$ 10,944,050

Computation of tax benefit:

Total compensation cost of average outstanding options	$ 13,110,825[f]
Intrinsic value of average outstanding options for the year ended December 31, 20X7 [892,500 × ($44 – $30)]	(12,495,000)
Excess of total compensation cost over estimated tax deduction	615,825
Tax benefit deficiency ($615,825 × .35)	$ 215,539

Assumed repurchase of shares:

Repurchase shares at average market price during the year ($37,503,511 ÷ $44)	852,353
Incremental shares (892,500 – 852,353)	40,147

Computation of Diluted EPS for the Year Ended December 31, 20X7:

Net income	$ 97,385,602
Weighted-average common shares outstanding	25,000,000
Incremental shares	40,147
Total shares outstanding	25,040,147
Diluted earnings per share	$ 3.89

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[a]This guidance also applies if the service inception date precedes the grant date.

[b]Pre-tax annual share-based compensation cost is $4,022,151 [(821,406 × $14.69) ÷ 3]. After-tax share-based compensation cost included in net income is $2,614,398 ($4,022,151 – $1,407,753). ($4,022,151 × .35) = $1,407,753.

[c]Share options granted at the beginning of the year plus share options outstanding at the end of the year divided by two equals the weighted-average number of share options outstanding in 20X7: [(900,000 + 885,000) ÷ 2] = 892,500. This example assumes that forfeitures occurred ratably throughout 20X7.

[d]885,000 (options outstanding at December 31, 20X7) – 821,406 (options for which the requisite service is expected to be rendered) = 63,594. 63,594 options × $14.69 (grant-date fair value per option) = $934,196 (total fair value). $934,196 ÷ 3 = $311,399 (annual share-based compensation cost).

[e]15,000 (forfeited options) × $14.69 (grant-date fair value per option) = $220,350 (total fair value).

[f](892,500 × $14.69) = $13,110,825.

D15. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* is amended as follows:

a. Paragraph 11(b):

> Contracts issued by the entity that are subject to FASB Statement No. 123 (revised 2004), *Share-Based Payment*~~in connection with stock-based compensation arrangements addressed in FASB Statement No. 123, *Accounting for Stock-Based Compensation.*~~ If any such contract ceases to be subject to Statement 123(R) in accordance with paragraph A231 of that Statement, the terms of that contract shall then be analyzed to determine whether the contract is subject to this Statement.

D16. FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,* is amended as follows:

a. Paragraph 17:

> This Statement does not apply to obligations under ~~stock~~share-based compensation arrangements if those obligations are accounted for under ~~APB Opinion No. 25,~~ ~~*Accounting for Stock Issued to Employees,*~~ FASB Statement No. 123 (revised 2004), ~~*Accounting for Stock-Based Compensation*~~*Share-Based Payment,* AICPA Statement of Position (SOP) 93-6, *Employers' Accounting for Employee Stock Ownership Plans,* or related guidance. However, this Statement does apply to a freestanding financial instrument that was issued under a ~~stock~~share-based compensation arrangement but is no longer subject to ~~Opinion 25,~~ Statement 123(R), SOP 93-6, or related guidance. For example, this Statement applies to mandatorily redeemable shares issued upon an employee's exercise of an employee ~~stock~~share option.

b. Paragraph D1:

> **Nonpublic entity**
>
> Any entity other than one (a) whose equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market, or (c) that is controlled by an entity covered by (a) or (b). [Statement 123(R), paragraph ~~395~~E1]

D17. FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities,* is amended as follows:

a. Footnote 18:

> The term *public entity* is defined in paragraph ~~395~~E1 of FASB Statement No. 123 (revised 2004), ~~*Accounting for Stock-Based Compensation*~~*Share-Based Payment.*

b. Footnote 23:

> The term *nonpublic entity* is defined in paragraph ~~395~~E1 of Statement 123(R).

D18. FASB Technical Bulletin No. 97-1, *Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option,* is amended as follows:

a. The Reference:

> FASB Statement No. 123 (revised 2004), ~~*Accounting for Stock-Based Compensation*~~*Share-Based Payment,* paragraphs 12–14 and~~23 and 24~~, ~~232–242~~A211–A219~~348–356~~.

b. Paragraph 1:

> The accounting guidance in this Technical Bulletin addresses the accounting under Statement 123(R) for certain employee stock purchase plans (ESPPs) with a look-back option. An example of a *look-back option* is a provision in an ESPP that establishes the purchase price as an amount based on the lesser of the stock's market price at the grant date or its market price at the exercise (or purchase) date. This Technical Bulletin does not address~~ the accounting for those plans under APB Opinion No. 25, *Accounting for Stock Issued to Employees*. It also does not address~~ the effect of those plans on earnings per share calculations.[1]

c. Paragraph 2:

> Paragraph 12~~23~~ of Statement 123(R) establishes the criteria under which an ESPP should be evaluated to determine whether it qualifies for noncompensatory treatment. If a plan does not meet *all* of those criteria, the fair value method of accounting must be used. ~~Paragraph 24 notes that a plan provision such as a look-back option is one feature that causes an ESPP to be considered compensatory. Paragraph 239 explains in part the Board's rationale:~~
>
>> ~~The Board considered respondents' requests that broad-based plans with look-back options be considered noncompensatory and noted that a look-back option can have substantial value because it enables the employee to purchase the stock for an amount that could be significantly less than the market price at date of purchase. A look-back option is not an essential element of a broad-based plan aimed at promoting broad employee stock ownership; a purchase discount also provides inducement for participation. The Board concluded that broad-based plans that contain look-back options cannot be treated as noncompensatory.~~

d. All references to *Illustration 9* or *Illustration 9 of Appendix B* of Statement 123 in paragraphs 3, 5, 6, 9, 10, 12–15, and 21 and footnote 7 are replaced by *Illustration 19* of Statement 123(R).

e. Footnote 2:

> The examples in Illustration ~~9~~ 19 of Statement 123(R) and this Technical Bulletin illustrate the use of the Black-Scholes-Merton option-pricing ~~model~~formula (a closed-form model). It also may be acceptable to use other valuation~~a binomial option pricing~~ models (for example, a lattice model) to value an award under an ESPP with a look-back option.

f. Paragraph 7:

> Although many ESPPs with a look-back option initially limit the maximum number of shares of stock that the employee is permitted to purchase under the plan (Type A plans), other ESPPs (Type B plans) do not fix the number of shares that the employee is permitted to purchase if the exercise date stock price is lower than the grant date stock price. In effect, an ESPP that does not fix the number of shares that may be purchased has guaranteed that the employee can always receive the value associated with *at least* 15 percent of the stock price at the grant date (the employee can receive much more than 15 percent of the grant date value of the stock if the stock appreciates during the look-back period). That provision provides the employee with the equivalent of a put option on 15 percent of the shares with an exercise price equal to the stock price at the grant date. In contrast, an employee who participates in a Type A plan is only guaranteed 15 percent of *the lower of* the stock price as of the grant date or the exercise date, which is the equivalent of a call option on 85 percent of the shares (as described more fully in paragraph ~~352~~A215 of Statement 123(R)). A participant in a Type B plan receives the equivalent of both a put option and a call option.

g. Paragraph 8:

> The following example illustrates that fundamental difference.[2a] [*Note:* the remainder of this paragraph is unchanged.]

[2a] The assumptions used for the numerical calculations in this Technical Bulletin are not intended to be the same as those in Illustration 19 of Statement 123(R). Rather, they are independent and designed to illustrate how the component measurement approach in Illustration 19 would be modified to reflect various features of employee stock purchase plans.

h. Paragraph 17:

Likewise, although not a change to the terms of the ESPP, an election by an employee to increase withholding amounts (or percentages) for future services (Type F through Type H plans) is a modification of the terms of the award to that employee, which, in substance, is similar to an exchange of the original award for a new award with different terms. Accordingly, the fair value of an award under an ESPP with variable withholdings should be determined at the grant date (using the Type A, Type B, or Type C measurement approach, as applicable) based on the estimated amounts (or percentages) that a participating employee initially elects to withhold under the terms of the plan. Subsequent to the grant date (except as noted in paragraph 23), any increases in withholding amounts (or percentages) for future services should be accounted for as a plan modification in accordance with the guidance in paragraph ~~35~~51 of Statement 123(R).

i. Paragraph 18:

Paragraph ~~35~~51 of Statement 123(R) explains the approach that should be used to account for a modification of the terms of an award as follows:

> A **modification** of the terms or conditions of an equity award ~~that makes it more valuable~~ shall be treated as an exchange of the original award for a new award.[26] In substance, the entity repurchases the original instrument by issuing a new instrument of equal or greater value, incurring additional compensation cost for ~~that~~ any incremental value. ~~The incremental value shall be measured by the difference between (a) the fair value of the modified option determined in accordance with the provisions of this Statement and (b) the value of the old option immediately before its terms are modified, dete[rmined based on the shorter of (1) its remaining expected life or (2) the expected life of the modified option.~~ The effects of a modification shall be measured as follows:
>
> a. Incremental compensation cost shall be measured as the excess, if any, of the fair value of the modified award determined in accordance with the provisions of this Statement over the fair value of the original award immediately before its terms are modified, measured based on the share price and other pertinent factors at that date.[27] The effect of the modification on the number of instruments expected to vest also shall be reflected in determining incremental compensation cost. The estimate at the

modification date of the portion of the award expected to vest shall be subsequently adjusted, if necessary, in accordance with paragraphs 43–45 and other guidance in Illustration 13 (paragraphs A160–A170).

b. Total recognized compensation cost for an equity award shall at least equal the fair value of the award at the grant date unless at the date of the modification the performance or service conditions of the original award are not expected to be satisfied. Thus, the total compensation cost measured at the date of a modification shall be (1) the portion of the grant-date fair value of the original award for which the requisite service is expected to be rendered (or has already been rendered) at that date plus (2) the incremental cost resulting from the modification. Compensation cost shall be subsequently adjusted, if necessary, in accordance with paragraphs 43–45 and other guidance in Illustration 13 (paragraphs A160–A170).

c. A change in compensation cost for an equity award measured at intrinsic value in accordance with paragraph 25 shall be measured by comparing the intrinsic value of the modified award, if any, with the intrinsic value of the original award, if any, immediately before the modification.

Illustrations 12–14 (paragraphs A149–A189) provide additional guidance on, and illustrate the accounting for, modifications of both vested and nonvested awards, including a modification that changes the classification of the related financial instruments from equity to liability or vice versa, and modifications of vesting conditions. Illustration 22 (paragraphs A225–A232) provides additional guidance on accounting for modifications of certain freestanding financial instruments that initially were subject to this Statement but subsequently became subject to other applicable GAAP.

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[26]A modification of a liability award also is accounted for as the exchange of the original award for a new award. However, because liability awards are remeasured at their fair value (or intrinsic value for a nonpubllic entity that elects that method) at each reporting date, no special guidance is necessary in accounting for a modification of a liability award that remains a liability after the modification.

[27]As indicated in paragrpah 23, footnote 13, references to *fair value* throughout paragraphs 24–85 of this Statement should be read also to encompass *calculated value.*

j. Paragraph 20:

> Any decreases in the withholding amounts (or percentages) should be disregarded for purposes of recognizing compensation cost unless the employee services that were valued at the grant date will no longer be provided to the employer due to a termination. However, no compensation cost should be recognized for awards that an employee forfeits because of failure to satisfy a service requirement for vesting. The accounting for decreases in withholdings is consistent with the requirement in paragraph ~~26~~43 of Statement 123(R) that the total amount of compensation cost that must be recognized for an award is based on the number of instruments ~~that vest rather than the number of instruments that are either granted or exercised~~for which the requisite service has been rendered (that is, for which the requisite service period has been completed).

k. Paragraph 24 and its related footnote 13:

> In some circumstances, applying the measurement approaches described in this Technical Bulletin at the grant date may not be practicable for certain types of ESPPs. ~~For example, an entity may not have access at a reasonable cost to the modeling capabilities needed to determine the fair value of plans with features in addition to or different from those described in this Technical Bulletin.~~ If it is *not practicable* to reasonably estimate fair value at the grant date, the guidance in paragraph ~~22~~25 of Statement 123(R) would apply.[13] Paragraph 25 of Statement 123(R) states:
>
>> An equity instrument for which~~If~~ it is not possible to reasonably estimate ~~the~~ fair value ~~of an option or other equity instrument at the grant date~~at the grant date shall be accounted for based on its intrinsic value, remeasured at each reporting date through the date of exercise or other settlement. T~~t~~he final measure of compensation cost shall be the ~~fair~~intrinsic value of the instrument at the date it is settled ~~based on the stock price and other pertinent factors at the first date at which it is possible to reasonably estimate that value~~. Compensation cost for each period until settlement shall be based on the change (or a portion of the change, depending on the percentage of the requisite service that has been rendered at the reporting date) in the intrinsic value of the instrument in each reporting period. The entity shall continue to use the intrinsic value method for those instruments even if it subsequently concludes that it is possible to reasonably estimate their fair value. ~~Generally, that is likely to be the date at which the number of shares to which an~~

~~employee is entitled and the exercise price are determinable. Estimates of compensation cost for periods during which it is not possible to determine fair value shall be based on the current intrinsic value of the award, determined in accordance with the terms that would apply if the option or similar instrument had been currently exercised.~~

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[13]Paragraphs ~~22~~24 and 25 of Statement 123(R) address~~es~~ circumstances in which the complexity of the terms of an~~characteristics of the~~ instrument prevent grant date measurement ~~using available option-pricing models~~ rather than circumstances in which an entity considers the amount of recordkeeping involved to be excessive.

Appendix E

GLOSSARY

E1. This appendix contains definitions of certain terms or phrases used in this Statement.

Blackout period

A period of time during which exercise of an equity share option is contractually or legally prohibited.

Broker-assisted cashless exercise

The simultaneous exercise by an employee of a share option and sale of the shares through a broker (commonly referred to as a *broker-assisted exercise*).

Generally, under this method of exercise:

a. The employee authorizes the exercise of an option and the immediate sale of the option shares in the open market.
b. On the same day, the entity notifies the broker of the sale order.
c. The broker executes the sale and notifies the entity of the sales price.
d. The entity determines the minimum statutory tax-withholding requirements.
e. By the settlement day (generally three days later), the entity delivers the stock certificates to the broker.
f. On the settlement day, the broker makes payment to the entity for the exercise price and the minimum statutory withholding taxes and remits the balance of the net sales proceeds to the employee.

Calculated value

A measure of the value of a share option or similar instrument determined by substituting the historical volatility of an appropriate industry sector index for the expected volatility of a nonpublic entity's share price in an option-pricing model.

Closed-form model

A valuation model that uses an equation to produce an estimated fair value. The Black-Scholes-Merton formula is a closed-form model. In the context of option valuation, both closed-form models and lattice models are based on risk-neutral valuation and a contingent claims framework. The payoff of a contingent claim,

and thus its value, depends on the value(s) of one or more other assets. The contingent claims framework is a valuation methodology that explicitly recognizes that dependency and values the contingent claim as a function of the value of the underlying asset(s). One application of that methodology is risk-neutral valuation in which the contingent claim can be replicated by a combination of the underlying asset and a risk-free bond. If that replication is possible, the value of the contingent claim can be determined without estimating the expected returns on the underlying asset. The Black-Scholes-Merton formula is a special case of that replication.

Combination award

An award with two or more separate components, each of which can be separately exercised. Each component of the award is actually a separate award, and compensation cost is measured and recognized for each component.

Cross-volatility

A measure of the relationship between the volatilities of the prices of two assets taking into account the correlation between movements in the prices of the assets. (Refer to the definition of **volatility.**)

Derived service period

A service period for an award with a market condition that is inferred from the application of certain valuation techniques used to estimate fair value. For example, the derived service period for an award of share options that the employee can exercise only if the share price increases by 25 percent at any time during a 5-year period can be inferred from certain valuation techniques. In a lattice model, that derived service period represents the duration of the median of the distribution of share price paths on which the market condition is satisfied. That median is the middle share price path (the midpoint of the distribution of paths) on which the market condition is satisfied. The duration is the period of time from the service inception date to the expected date of satisfaction (as inferred from the valuation technique). If the derived service period is three years, the estimated requisite service period is three years and all compensation cost would be recognized over that period, unless the market condition was satisfied at an earlier date.[170] Further, an award of fully vested, deep out-of-the-money share options has a derived service period that must be determined from the valuation techniques used to estimate fair value. (Refer to the definitions of **explicit service period, implicit service period,** and **requisite service period.**)

[170]Compensation cost would not be recognized beyond three years even if after the grant date the entity determines that it is not probable that the market condition will be satisfied within that period.

Economic interest in an entity

Any type or form of pecuniary interest or arrangement that an entity could issue or be a party to, including equity securities; financial instruments with characteristics of equity, liabilities, or both; long-term debt and other debt-financing arrangements; leases; and contractual arrangements such as management contracts, service contracts, or intellectual property licenses.

Employee

An individual over whom the grantor of a share-based compensation award exercises or has the right to exercise sufficient control to establish an employer-employee relationship based on common law as illustrated in case law and currently under U.S. Internal Revenue Service Revenue Ruling 87-41.[171] Accordingly, a grantee meets the definition of an employee if the grantor consistently represents that individual to be an employee under common law. The definition of an employee for payroll tax purposes under the U.S. Internal Revenue Code includes common law employees. Accordingly, a grantor that classifies a grantee potentially subject to U.S. payroll taxes as an employee for purposes of applying this Statement also must represent that individual as an employee for payroll tax purposes (unless the grantee is a leased employee as described below). A grantee does not meet the definition of an employee for purposes of this Statement solely because the grantor represents that individual as an employee for some, but not all, purposes. For example, a requirement or decision to classify a grantee as an employee for U.S. payroll tax purposes does not, by itself, indicate that the grantee is an employee for purposes of this Statement because the grantee also must be an employee of the grantor under common law.

A leased individual is deemed to be an employee of the lessee for purposes of this Statement if all of the following requirements are met:

a. The leased individual qualifies as a common law employee of the lessee, and the lessor is contractually required to remit payroll taxes on the compensation paid to the leased individual for the services provided to the lessee.
b. The lessor and lessee agree in writing to all of the following conditions related to the leased individual:
    1. The lessee has the exclusive right to grant stock compensation to the individual for the employee service to the lessee.

[171] A reporting entity based in a foreign jurisdiction would determine whether an employee-employer relationship exists based on the pertinent laws of that jurisdiction.

2. The lessee has a right to hire, fire, and control the activities of the individual. (The lessor also may have that right.)
3. The lessee has the exclusive right to determine the economic value of the services performed by the individual (including wages and the number of units and value of stock compensation granted).
4. The individual has the ability to participate in the lessee's employee benefit plans, if any, on the same basis as other comparable employees of the lessee.
5. The lessee agrees to and remits to the lessor funds sufficient to cover the complete compensation, including all payroll taxes, of the individual on or before a contractually agreed upon date or dates.

A nonemployee director does not satisfy this definition of employee. Nevertheless, for purposes of this Statement, nonemployee directors acting in their role as members of a board of directors are treated as employees if those directors were (a) elected by the employer's shareholders or (b) appointed to a board position that will be filled by shareholder election when the existing term expires. However, that requirement applies only to awards granted to nonemployee directors for their services as directors. Awards granted to those individuals for other services shall be accounted for as awards to nonemployees for purposes of this Statement.

Employee share ownership plan

An employee benefit plan that is described by the Employment Retirement Income Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock.

Equity restructuring

A nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying an option or similar award to change, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend.

Excess tax benefit

The realized tax benefit related to the amount (caused by changes in the fair value of the entity's shares after the **measurement date** for financial reporting) of deductible compensation cost reported on an employer's tax return for equity instruments in excess of the compensation cost for those instruments recognized for financial reporting purposes.

Explicit service period

A service period that is explicitly stated in the terms of a share-based payment award. For example, an award stating that it vests after three years of continuous employee service from a given date (usually the grant date) has an explicit service period of three years. (Refer to **derived service period, implicit service period,** and **requisite service period.**)

Fair value

The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

Freestanding financial instrument

A financial instrument that is entered into separately and apart from any of the entity's other financial instruments or equity transactions or that is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

Grant date

The date at which an employer and an employee reach a mutual understanding of the key terms and conditions of a share-based payment award. The employer becomes contingently obligated on the grant date to issue equity instruments or transfer assets to an employee who renders the requisite service. Awards made under an arrangement that is subject to shareholder approval are not deemed to be granted until that approval is obtained unless approval is essentially a formality (or perfunctory), for example, if management and the members of the board of directors control enough votes to approve the arrangement. Similarly, individual awards that are subject to approval by the board of directors, management, or both are not deemed to be granted until all such approvals are obtained. The grant date for an award of equity instruments is the date that an employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares. (Refer to the definition of **service inception date.**)

Implicit service period

A service period that is not explicitly stated in the terms of a share-based payment award but that may be inferred from an analysis of those terms and other facts and circumstances. For instance, if an award of share options vests upon the completion of a new product design and it is probable that the design

will be completed in 18 months, the implicit service period is 18 months. (Refer to **derived service period, explicit service period,** and **requisite service period.**)

Intrinsic value

The amount by which the fair value of the underlying stock exceeds the exercise price of an option. For example, an option with an exercise price of $20 on a stock whose current market price is $25 has an intrinsic value of $5. (A nonvested share may be described as an option on that share with an exercise price of zero. Thus, the fair value of a share is the same as the intrinsic value of such an option on that share.)

Issued, issuance, or **issuing** of an equity instrument

An equity instrument is issued when the issuing entity receives the agreed-upon consideration, which may be cash, an enforceable right to receive cash or another financial instrument, goods, or services. An entity may conditionally transfer an equity instrument to another party under an arrangement that permits that party to choose at a later date or for a specified time whether to deliver the consideration or to forfeit the right to the conditionally transferred instrument with no further obligation. In that situation, the equity instrument is not *issued* until the issuing entity has received the consideration. For that reason, this Statement does not use the term *issued* for the grant of stock options or other equity instruments subject to vesting conditions.

Lattice model

A model that produces an estimated fair value based on the assumed changes in prices of a financial instrument over successive periods of time. The binomial model is an example of a lattice model. In each time period, the model assumes that at least two price movements are possible. The lattice represents the evolution of the value of either a financial instrument or a market variable for the purpose of valuing a financial instrument. In this context, a lattice model is based on risk-neutral valuation and a contingent claims framework. (Refer to **closed-form model** for an explanation of the terms *risk-neutral valuation* and *contingent claims framework*.)

Market condition

A condition affecting the exercise price, exercisability, or other pertinent factors used in determining the fair value of an award under a share-based payment arrangement that relates to the achievement of (a) a specified price of the issuer's shares or a specified amount of intrinsic value indexed solely to the issuer's

shares or (b) a specified price of the issuer's shares in terms of a similar[172] (or index of similar) equity security (securities).

Measurement date

The date at which the equity share price and other pertinent factors, such as expected volatility, that enter into measurement of the total recognized amount of compensation cost for an award of share-based payment are fixed.

Modification

A change in any of the terms or conditions of a share-based payment award.

Nonpublic entity

Any entity other than one (a) whose equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market, or (c) that is controlled by an entity covered by (a) or (b). An entity that has only debt securities trading in a public market (or that has made a filing with a regulatory agency in preparation to trade only debt securities) is a nonpublic entity for purposes of this Statement.

Nonvested shares

Shares that an entity has not yet issued because the agreed-upon consideration, such as employee services, has not yet been received. Nonvested shares cannot be sold. The restriction on sale of nonvested shares is due to the forfeitability of the shares if specified events occur (or do not occur).

Performance condition

A condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to both (a) an employee's rendering service for a specified (either explicitly or implicitly) period of time and (b) achieving a specified performance target that is defined solely by reference to the employer's own operations (or activities). Attaining a specified growth rate in return on assets, obtaining regulatory approval to market a specified product, selling shares in an initial public offering or other financing event, and a change in control are examples of performance conditions for

[172]The term *similar* as used in this definition refers to an equity security of another entity that has the same type of residual rights. For example, common stock of one entity generally would be similar to the common stock of another entity for this purpose.

purposes of this Statement. A performance target also may be defined by reference to the same performance measure of another entity or group of entities. For example, attaining a growth rate in earnings per share that exceeds the average growth rate in earnings per share of other entities in the same industry is a performance condition for purposes of this Statement. A performance target might pertain either to the performance of the enterprise as a whole or to some part of the enterprise, such as a division or an individual employee.

Public entity

An entity (a) with equity securities that trade in a public market, which may be either a stock exchange (domestic or foreign) or an over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market, or (c) that is controlled by an entity covered by (a) or (b). That is, a subsidiary of a public entity is itself a public entity. An entity that has only debt securities trading in a public market (or that has made a filing with a regulatory agency in preparation to trade only debt securities) is not a public entity for purposes of this Statement.

Related party

An affiliate of the reporting entity; another entity for which the reporting entity's investment is accounted for by the equity method; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners and management of the entity; members of the immediate families of principal owners of the entity and its management; and other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests. This definition is the same as the definition of *related parties* in paragraph 24 of FASB Statement No. 57, *Related Party Disclosures*.

Reload feature and **reload option**

A reload feature provides for automatic grants of additional options whenever an employee exercises previously granted options using the entity's shares, rather than cash, to satisfy the exercise price. At the time of exercise using shares, the

employee is automatically granted a new option, called a *reload option*, for the shares used to exercise the previous option.

Replacement award

An award of share-based compensation that is granted (or offered to grant) concurrently with the cancellation of another award.

Requisite service period (and **requisite service)**

The period or periods during which an employee is required to provide service in exchange for an award under a share-based payment arrangement. The service that an employee is required to render during that period is referred to as the *requisite service*. The requisite service period for an award that has only a service condition is presumed to be the vesting period, unless there is clear evidence to the contrary. If an award requires future service for vesting, the entity cannot define a prior period as the requisite service period. Requisite service periods may be explicit, implicit, or derived, depending on the terms of the share-based payment award.

Restricted share

A share for which sale is contractually or governmentally prohibited for a specified period of time. Most grants of shares to employees are better termed *nonvested shares* because the limitation on sale stems solely from the forfeitability of the shares before employees have satisfied the necessary service or performance condition(s) to earn the rights to the shares. Restricted shares issued for consideration other than employee services, on the other hand, are fully paid for immediately. For those shares, there is no period analogous to a requisite service period during which the issuer is unilaterally obligated to issue shares when the purchaser pays for those shares, but the purchaser is not obligated to buy the shares. This Statement uses the term *restricted shares* to refer only to fully vested and outstanding shares whose sale is contractually or governmentally prohibited for a specified period of time.[173] (Refer to the definition of **nonvested shares.**)

Restriction

A contractual or governmental provision that prohibits sale (or substantive sale by using derivatives or other means to effectively terminate the risk of future changes in the share price) of an equity instrument for a specified period of time.

[173]Vested equity instruments that are transferable to an employee's immediate family members or to a trust that benefits only those family members are restricted if the transferred instruments retain the same prohibition on sale to third parties.

Service condition

A condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that depends solely on an employee rendering service to the employer for the requisite service period. A condition that results in the acceleration of vesting in the event of an employee's death, disability, or termination without cause is a service condition.

Service inception date

The date at which the requisite service period begins. The service inception date usually is the grant date, but the service inception date may differ from the grant date (refer to Illustration 3, paragraphs A79–A85).

Settle, settled, or **settlement** of an award

An action or event that irrevocably extinguishes the issuing entity's obligation under a share-based payment award. Transactions and events that constitute settlements include (a) exercise of a share option or lapse of an option at the end of its contractual term, (b) vesting of shares, (c) forfeiture of shares or share options due to failure to satisfy a vesting condition, and (d) an entity's repurchase of instruments in exchange for assets or for fully vested and transferable equity instruments. The vesting of a share option is not a settlement as that term is used in this Statement because the entity remains obligated to issue shares upon exercise of the option.

Share option

A contract that gives the holder the right, but not the obligation, either to purchase (to call) or to sell (to put) a certain number of shares at a predetermined price for a specified period of time. Most share options granted to employees under share-based compensation arrangements are call options, but some may be put options.

Share unit

A contract under which the holder has the right to convert each unit into a specified number of shares of the issuing entity.

Share-based payment (or **compensation) arrangement**

An arrangement under which (a) one or more suppliers of goods or services (including employees) receive awards of equity shares, equity share options, or other equity instruments or (b) the entity incurs liabilities to suppliers (1) in

amounts based, at least in part,[174] on the price of the entity's shares or other equity instruments or (2) that require or may require settlement by issuance of the entity's shares. For purposes of this Statement, the term *shares* includes various forms of ownership interest that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. *Equity shares* refers only to shares that are accounted for as equity.

Share-based payment (or **compensation**) **transaction**

A transaction under a share-based payment arrangement, including a transaction in which an entity acquires goods or services because related parties or other holders of economic interests in that entity awards a share-based payment to an employee or other supplier of goods or services for the entity's benefit.

Short-term inducement

An offer by the entity that would result in modification or settlement of an award to which an award holder may subscribe for a limited period of time.

Small business issuer

A public entity that is an SEC registrant that files as a small business issuer under the Securities Act of 1933 or the Securities Exchange Act of 1934. At the date this Statement was issued, a *small business issuer* was defined as an entity that meets all of the following criteria:

a. It has revenues of less than $25 million.
b. It is a U.S. or Canadian issuer.
c. It is not an investment company.
d. If the entity is a majority-owned subsidiary, the parent company also is a small business issuer.

However, regardless of whether it satisfies those criteria, an entity is not a small business issuer if the aggregate market value of its outstanding securities held by nonaffiliates is $25 million or more.

[174]The phrase *at least in part* is used because an award may be indexed to both the price of the entity's shares and something other than either the price of the entity's shares or a market, performance, or service condition.

The definition of a small business issuer is a matter of U.S. federal securities law and is subject to change. The effective date provisions of this Statement for a small business issuer apply only to an entity that files as a small business issuer under the related definition at that date.

Tandem award

An award with two (or more) components in which exercise of one part cancels the other(s).

Terms of a share-based payment award

The contractual provisions that determine the nature and scope of a share-based payment award. For example, the exercise price of share options is one of the terms of an award of share options. As indicated in paragraph 34 of this Statement, the written terms of a share-based payment award and its related arrangement, if any, usually provide the best evidence of its terms. However, an entity's past practice or other factors may indicate that some aspects of the substantive terms differ from the written terms. The substantive terms of a share-based payment award as those terms are mutually understood by the entity and a party (either an employee or a nonemployee) who receives the award provide the basis for determining the rights conveyed to a party and the obligations imposed on the issuer, regardless of how the award and related arrangement, if any, are structured. Also refer to paragraph 6 of this Statement.

Time value of an option

The portion of the fair value of an option that exceeds its intrinsic value. For example, a call option with an exercise price of $20 on a stock whose current market price is $25 has intrinsic value of $5. If the fair value of that option is $7, the time value of the option is $2 ($7 – $5).

Vest, Vesting, or **Vested**

To earn the rights to. A share-based payment award becomes vested at the date that the employee's right to receive or retain shares, other instruments, or cash under the award is no longer contingent on satisfaction of either a service condition or a performance condition. Market conditions are not vesting conditions for purposes of this Statement.

For convenience and because the terms are commonly used in practice, this Statement refers to *vested* or *nonvested* options, shares, awards, and the like, as well as *vesting date*. The stated vesting provisions of an award often establish the requisite service period, and an award that has reached the end of the requisite service period is vested. However, as indicated in the definition of *requisite*

service period, the stated vesting period may differ from the requisite service period in certain circumstances. Thus, the more precise (but cumbersome) terms would be *options, shares,* or *awards for which the requisite service has been rendered* and *end of the requisite service period*.

Volatility

A measure of the amount by which a financial variable such as a share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. Volatility also may be defined as a probability-weighted measure of the dispersion of returns about the mean. The volatility of a share price is the standard deviation of the continuously compounded rates of return on the share over a specified period. That is the same as the standard deviation of the differences in the natural logarithms of the stock prices plus dividends, if any, over the period. The higher the volatility, the more the returns on the shares can be expected to vary—up or down. Volatility is typically expressed in annualized terms.

Appendix F

STATUS OF RELATED AUTHORITATIVE LITERATURE

F1. The following table reflects the current authoritative literature as of December 16, 2004, relating to share-based payment transactions that remain in effect upon issuance of this Statement.

AICPA Literature	Title
SOP 76-3	Accounting Practices for Certain Employee Stock Ownership Plans
SOP 93-6	Employers' Accounting for Employee Stock Ownership Plans

EITF Issue No.	Title
96-18	Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services
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
97-14	Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested
00-8	Accounting by a Grantee for an Equity Instrument to Be Received in Conjunction with Providing Goods or Services
00-12	Accounting by an Investor for Stock-Based Compensation Granted to Employees of an Equity Method Investee
00-16	Recognition and Measurement of Employer Payroll Taxes on Employee Stock-Based Compensation
00-18	Accounting Recognition for Certain Transactions involving Equity Instruments Granted to Other Than Employees

EITF Issue No.	Title
00-19	Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock
01-1	Accounting for a Convertible Instrument Granted or Issued to a Nonemployee for Goods or Services or a Combination of Goods or Services and Cash
01-6	The Meaning of "Indexed to a Company's Own Stock"
02-8	Accounting for Options Granted to Employees in Unrestricted, Publicly Traded Shares of an Unrelated Entity
D-83	Accounting for Payroll Taxes Associated with Stock Option Exercises
D-90	Grantor Balance Sheet Presentation of Unvested, Forfeitable Equity Instruments Granted to a Nonemployee

F2. Issuance of this Statement eliminates the need for the following EITF Issues (the status section in EITF *Abstracts* will be updated accordingly).

EITF Issue No.	Title	Effect of Statement on Consensus
84-8	Variable Stock Purchase Warrants Given by Suppliers to Customers	Resolved
84-13	Purchase of Stock Options and Stock Appreciation Rights in a Leveraged Buyout	Nullified—Unnecessary[175]
84-18	Stock Option Pyramiding	Nullified—Unnecessary

[175]The consensus is considered no longer necessary because this Statement changed or eliminated the need for the guidance or because the guidance is considered an unnecessary level of detail.

EITF Issue No.	Title	Effect of Statement on Consensus
84-34	Permanent Discount Restricted Stock Purchase Plans	Nullified—Unnecessary
85-45	Business Combinations: Settlement of Stock Options and Awards	Nullified—Unnecessary
87-23	Book Value Stock Purchase Plans	Nullified—Unnecessary
88-6	Book Value Stock Plans in an Initial Public Offering	Nullified—Unnecessary
90-7	Accounting for a Reload Stock Option	Nullified—Unnecessary
95-16	Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25	Nullified—Unnecessary
97-5	Accounting for the Delayed Receipt of Options Shares upon Exercise under APB Opinion No. 25	Nullified—Unnecessary
97-12	Accounting for Increased Share Authorizations in an IRS Section 423 Employee Stock Purchase Plan under APB Opinion No. 25	Nullified—Unnecessary
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	Nullified—Unnecessary
00-23	Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44	Nullified—Unnecessary
D-18	Accounting for Compensation Expense If Stock Appreciation Rights Are Cancelled	Nullified—Unnecessary

EITF Issue No.	Title	Effect of Statement on Consensus
D-91	Application of APB Opinion No. 25 and FASB Interpretation No. 44 to an Indirect Repricing of a Stock Option	Nullified—Unnecessary
D-93	Accounting for the Rescission of the Exercise of Employee Stock Options	Nullified—Unnecessary

Impact of This Statement on Statement 133 Implementation Issues

F3. This Statement modifies the responses in the following Statement 133 Implementation Issues.

Statement 133 Implementation No.	Title
C3	Exception Related to Stock-Based Compensation Arrangements
E19	Methods of Assessing Hedge Effectiveness When Options Are Designated as the Hedging Instrument
G1	Hedging an SAR Obligation